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Department of the Treasury

PRESS RELEASES

Number not used HP-1062.

July 1, 2008
HP-1063

Under Secretary McCormick Statement
on World Bank Approval of Clean Technology Fund

"The United States welcomes the World Bank's decision today to establish a $5-$10 billion international clean technology fund that will reduce greenhouse gas emissions growth in the fastest growing developing countries by promoting low-carbon development.

"We have been working closely with the Bank's leadership, potential donor and recipient countries, as well as the environmental and business communities, to develop a Fund that effectively addresses the dual challenges of poverty and climate change.

"The President has requested from Congress $2 billion over the next three years for the Fund to support immediate action to help reduce greenhouse gas emissions in developing countries where they are growing the fastest through the deployment of commercially available clean technology."

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July 2, 2008
HP-1064

Remarks by U.S. Treasury Secretary Henry M. Paulson, Jr. on the U.S., the World Economy and Markets before the Chatham House

London - Thank you, Robin. I am pleased to be in London again. Today I will provide my perspective on current U.S. and global economic conditions and then look forward to your questions.

When President Bush visited the United Kingdom last month, Prime Minister Brown remarked on the similarities between our countries -- that both are "founded upon liberty, our histories forged through democracy, our shared values expressed by a commitment to opportunity for all." And indeed our countries are loyal and true allies, our people are friends and we stand and work together on the world economic stage.

U.S. Economy

Today, the U.S. economy is going through a rough period. And while we have seen better growth in Europe over the last few quarters, there are signs of a slowdown in Europe in general and the UK specifically. However, emerging economies are expected to continue a period of strong growth, which will support global growth overall.

Early this year, President Bush and the U.S. Congress enacted an economic stimulus package that is injecting $150 billion into the U.S. economy now when it's most needed. To date, almost 95 million payments totaling over $78 billion have been sent. Consumer spending data in May show these payments are helping families weather this period of slow growth and higher food and gas prices.

Still, the U.S. economy is facing a trio of headwinds: high energy prices, capital markets turmoil and a continuing housing correction.

U.S. Housing Market

While we have implemented several public and private initiatives to prevent avoidable foreclosures, the housing correction continues to pose a significant downside risk to the U.S. economy. As the market works through past excesses, U.S. foreclosures will remain elevated and we should not be surprised at continued reports of falling home prices. Our policy continues to be to work to avoid preventable foreclosures while not impeding the necessary correction because the sooner housing prices stabilize and more buyers return to the market the sooner housing will begin to contribute to economic growth.

U.S. and Global Capital Markets

Today I will focus on our capital markets – where the United States and the United Kingdom face similar challenges and are pursuing similar approaches. I see our work in three tranches; first and foremost, our number one priority continues to be promoting market stability and limiting the impact on the broader economy as we work through today's institutional and markets stresses. Second, implementing the appropriate policy responses to recent events to address the deficiencies in our markets which the current problems have exposed. Third, improving our overall financial regulatory structure to better prevent and address future turmoil.

Working through the current turmoil will take additional time, as markets and financial institutions continue to reassess risk, and re-price securities across a number of asset classes and sectors. I have encouraged financial institutions to de-lever, recognize and disclose losses and raise capital, so they can continue to play

their vital role in supporting economic growth. Even in this difficult environment, financial institutions worldwide have raised over $338 billion. Institutions in the U.S. and the U.K. have raised capital equal to 95 and 96 percent of their recognized losses, respectively. In continental Europe, the gap is wider; there, institutions have raised only 56 percent of their recognized losses so far. I encourage financial institutions to continue to strengthen balance sheets by raising capital, de-leveraging or reviewing dividend policies.

Today's markets are difficult and this is a tough earnings environment for our financial institutions as they work through the present market turmoil and adjust to the underlying challenges in our economy. For example, high oil prices will in all likelihood prolong our economic slowdown and housing continues to pose a significant downside risk.

U.S. Response to Policy Issues Arising from Market Turmoil

As the United States and international capital markets work through the immediate turmoil, policymakers around the world have been focused on addressing the policy implications.

In the United States, the Treasury Department, the Federal Reserve, the Securities and Exchange Commission and the Commodities Futures Trading Commission worked together through the President's Working Group on Financial Markets, the PWG, to recommend and implement specific near-term policy actions. U.S. regulators, investors, financial institutions and credit ratings agencies have begun to implement these and other recommendations, which include stronger mortgage origination oversight, national licensing standards for mortgage brokers, and actions to improve market infrastructure, regulatory oversight, risk management practices, steps to address valuation issues, and policies and practices related to the credit ratings agencies and the mortgage securitization chain.

International Policy Response to Market Turmoil

From the outset, U.S. and world policymakers knew that the interconnectedness of U.S. and global markets required an internationally coordinated response. Throughout this process, we have been in regular contact and worked closely with our international colleagues, particularly with the UK. At our meeting last October, the G7 tasked the Financial Stability Forum, the FSF, to analyze the underlying causes of the turbulence and offer proposals for change. The FSF, which brings together the supervisors, central banks, and finance ministries of major financial centers, has done its work quickly and effectively, and recently produced 67 recommendations. These are consistent with and complement efforts in the United States.

We have already seen progress on the implementation: an updated code of conduct for credit rating agencies has been issued and is being implemented; disclosure practices have been published and are being put in place; and the Basel Committee just issued updated bank liquidity guidance. A large number of other projects are well underway, and the FSF is closely monitoring progress. The United Kingdom and European nations are taking a number of other actions that support and reinforce the FSF recommendations.

There is no easy solution that will immediately relieve current financial market stress or protect against future problems and market challenges which will inevitably occur. Together, the United States, the United Kingdom, other nations and the FSF are addressing current challenges and the underlying weaknesses that contributed to present economic circumstances.

Vision for a Modern U.S. Financial Regulatory Structure

That said, I believe we in the United States need to go further – to address not only the specific policy issues that gave rise to recent turmoil, but also the outdated nature of the U.S. financial regulatory system. Few, if any, defend our current balkanized system as optimal.

Treasury made our recommendations for an optimal structure when we released our Blueprint for a Modernized Financial Regulatory Structure last March. We

recommend a U.S. regulatory model based on objectives that more closely link the regulatory structure to the reasons why we regulate. Our model proposes three primary regulators: one focused on market stability across the entire financial sector, another focused on safety and soundness of institutions supported by a federal guarantee, and a third focused on protecting consumers and investors.

A major advantage of this structure is its timelessness and its flexibility. Because it is organized by regulatory objective rather than by financial institution category, it can more easily respond and adapt to the ever-changing marketplace. These recommendations eliminate regulatory competition that creates inefficiencies and can engender a race to the bottom.

We began work on this Blueprint well before our current challenges emerged. Our goal then, which has only accelerated now, is to modernize the U.S. financial regulatory structure to better reflect modern financial markets. Of course, regulation alone cannot fully protect the financial system. Market discipline must also constrain risk-taking. Finding the right balance between market discipline and market oversight is critical to maintaining the market stability and innovation necessary to support vibrant economic growth.

When we released the Blueprint, I was clear that it was a long-term vision that would take time to consider and implement. That is still the case, but today we have both a clear need and a unique opportunity to accelerate this process. The Bear Stearns episode and market turmoil more generally have placed in stark relief the outdated nature of our financial regulatory system. We are working with the Fed and the SEC on the immediate issues raised by the Fed's provision of liquidity to the primary dealers, an extraordinary step taken in the wake of Bear Stearns and one that was necessary to ensure the stability and orderliness of our financial system.

The Bear Stearns episode highlighted the need for the Fed and SEC to work constructively together including an MOU that should be helpful and inform future decisions as our Congress considers how to modernize and improve our regulatory structure.

In addition to the MOU, there are three important steps that the United States should take in the near term, all of which move us further in the direction of the optimal regulatory structure outlined in the Blueprint.

First, whether it was Long Term Capital Management in 1998 or Bear Stearns this year, it is clear that Americans have come to expect the Federal Reserve to step in to avert events that pose unacceptable systemic risk. But, as we noted in our Blueprint, the Fed has neither the clear statutory authority nor the mandate to attempt to anticipate and prevent risks across our entire financial system. Therefore we should consider how most appropriately to give the Federal Reserve the information and authority necessary to play its expected role of market stability regulator. The Fed would need the authority to access necessary information from complex financial institutions -- whether it is a commercial bank, an investment bank, a hedge fund, or another type of financial institution -- and the tools to intervene to mitigate systemic risk in advance of a crisis.

This is a tall order. History teaches us that in a dynamic market economy regulation alone cannot eliminate instability. To be clear, I do not believe that we can eliminate, by regulation or otherwise, all future bouts of market instability -- they are difficult to predict and past history may be a poor predictor of the future. However, just because the overall task is difficult, we should not stop trying to understand and mitigate instability.

To that end, we should create a system that gives us the best chance of foreseeing a crisis, including a market stability regulator with the authorities to avert systemic issues it foresees and providing the information, tools and authorities to deal better with unexpected events when they inevitably occur.

To complement this regulator's efforts, we must have strong market discipline to reinforce the stability of our markets. For market discipline to be effective it is imperative that market participants not have the expectation that lending from the Fed, or any other government support, is readily available. Otherwise, market discipline will be compromised severely. I know from first hand experience that

normal or even presumed access to a government backstop has the potential to change behavior within financial institutions and with their creditors. It compromises market discipline and lowers risk premiums, ultimately putting the system at greater risk.

So how do we strengthen market discipline? Today's priority is clearly market stability. However, looking beyond the immediate turmoil, we need to design carefully and put in place a stronger capacity for resolution and crisis intervention that reinforces market discipline. In an optimal system, market discipline effectively constrains risk because the regulatory structure is strong enough that a financial institution can fail without threatening the overall system. For market discipline to constrain risk effectively, financial institutions must be allowed to fail. Under optimal financial regulatory and financial system infrastructures, such a failure would not threaten the overall system.

However, today two concerns underpin expectations of regulatory intervention to prevent a failure. They are that an institution may be too interconnected to fail or too big to fail. We must take steps to reduce the perception that this is so -- and that requires that we reduce the likelihood that it is so.

Strengthening market infrastructure will reduce the expectation that an institution is too interconnected to fail. We need to strengthen our practices and financial infrastructure in the OTC derivatives market and in the tri-party repo system. Important work is underway in each of these areas, and needs to be completed quickly.

To address the perception that some institutions are too big to fail, we must improve the tools at our disposal for facilitating the orderly failure of a large complex financial institution. As former Federal Reserve Chairman Greenspan often noted, the real issue is not that an institution is too big or too interconnected to fail, but that it is too big or interconnected to liquidate quickly.

Today, our tools are limited. We have the Fed's broad lender of last resort powers which are currently being used to help stabilize our markets. Current law also allows our President to declare a national economic emergency, and then dictate the actions of commercial banks. But this tool is both too blunt, in that exercising it would likely spur greater concern and too narrow, in that commercial banks are only one group of participants in today's broad financial markets. We also have specialized resolution provisions that apply solely to insured depository institutions, but these do not apply to a large group of complex financial companies.

In general, bankruptcy law serves as the resolution regime for non-depository financial institutions and most corporations. This regime has a long legal history, and is initiated by private-sector decisions to initiate bankruptcy proceedings, which then start a process to pay claims. In contrast, under the administrative procedures for insured depository institutions, regulators determine when and how to start the proceeding and in many ways regulators largely take the place of the courts in determining the allocation of claims.

These two very different approaches for resolution have advantages and disadvantages. Bankruptcy imposes market discipline on creditors, but in a time of crisis could involve undue market disruption. An administrative procedure under the control of regulators helps to mitigate market disruption, but can reduce market discipline. For insured depository institutions, this special insolvency regime was deemed necessary because of the role these institutions play in the overall financing of economic activity and the presence of a government guarantee.

As I have continually noted, the financial landscape has changed, and non-bank financial institutions play a significantly greater role. We need to consider broadly the resolution regime in light of these changes. It is clear that some institutions, if they fail, can have a systemic impact, so we must give regulators the authorities to limit that impact and facilitate an orderly failure. In my view, looking beyond the immediate market challenges of today, we need to create a resolution process that ensures the financial system can withstand the failure of a large complex financial firm. To do this, we will need to give our regulators additional emergency authority to limit temporary disruptions. These authorities should be flexible and -- to reinforce market discipline -- the trigger for invoking such authority should be very high, such as a bankruptcy filing. And as part of this process we should consider ways to ensure that costs are imposed on creditors and equity holders. Any

commitment of government support should be an extraordinary event that requires the engagement of the Executive Branch. It should be focused on areas with the greatest potential for market instability and should contain sufficient criteria to ensure that the cost to the taxpayers is minimized.

In the United Kingdom, you gave recently proposed changes to your regulatory system as the United States is doing now. While your regulatory system is different from ours, we both recognize the direction our systems must take to better deal with market stability issues and today's financial markets. In the U.K., colleagues have recently proposed modifications to your regulatory structure and authorities similar to what Treasury envisioned in our Blueprint. Under this new proposal, the Bank of England would be given specific statutory responsibility for financial stability regulation. A new Financial Stability Committee, chaired by the Governor of the Bank of England, would oversee the Bank's functions as they relate to market stability. The Bank of England would also have new authorities to carry out this function, including access to firm-specific information related to market stability, formal oversight of payment systems, as we are recommending for the Federal Reserve in the U.S., and a lead role in working with the FSA to establish a new resolution regime.

As U.S. and global regulators respond to recent events, we must recognize that the stability and vitality of our markets require both robust oversight and market discipline.

Conclusion

The United States and the United Kingdom share a long history and a bright future. As we cooperate and work closely with you during this period of economic difficulty we look forward to emerging, as we always do, to a new day of promise and prosperity. Thank you.

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July 2, 2008
HP-1065

Treasury Identifies New Aliases of Al Rashid and Al-Akhtar Trusts Pakistan-Based Trusts Previously Designated for Supporting al Qaida

Washington - The U.S. Department of the Treasury today added to its list of Specially Designated Global Terrorists (SDGTs) new aliases under which Al Rashid Trust and Al-Akhtar Trust International are operating in an apparent effort to circumvent sanctions imposed by the United States and the United Nations.

"We are very concerned about designated entities reconstituting themselves under new names in attempts to circumvent sanctions and continue funneling money to terrorist activities," said Adam J. Szubin, Director of the Office of Foreign Assets Control (OFAC). "OFAC will continue to put the public on notice when we find that a designated entity is trying to operate under the cloak of a new alias."

Al Rashid Trust
AKA: Al Amin Welfare Trust
AKA: Al Amin Trust
AKA: Al Ameen Trust
AKA: Al-Ameen Trust
AKA: Al Madina Trust
AKA: Al-Madina Trust

Al Rashid Trust was designated on September 23, 2001, in the Annex to Executive Order 13224 and was added to the UN 1267 Committee's List of individuals and entities associated with Usama bin Laden, al Qaida or the Taliban on April 24, 2002. As of mid- 2007, Al Rashid Trust was operating under the name Al Amin Welfare Trust and the other AKAs listed above.

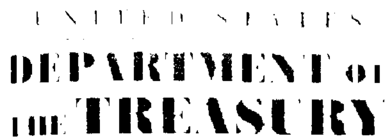
A1-Akhtar Trust International
AKA: Pakistan Relief Foundation
AKA: Pakistani Relief Foundation
AKA: Azmat-e-Pakistan Trust
AKA: Azmat Pakistan Trust

Al-Akhtar Trust International was designated pursuant to E.O. 13224 on October 14, 2003, and was added to the UN 1267 Committee's List on August 17, 2005. As of July 2007, A1-Akhtar Trust International was using the alternate name Pakistan Relief Foundation and the other AKAs listed above. As of May 2007, Pakistan Relief Foundation had taken over all assets of Al-Akhtar Trust, and Al-Akhtar Trust's senior leaders had begun working on behalf of Pakistan Relief Foundation.

Al Rashid Trust, Al-Akhtar Trust International, and the AKAs named today are designated under Executive Order 13224, which targets terrorists, those owned or controlled by or acting for or on behalf of terrorists, and those providing financial, technological, or material support to terrorists or acts of terrorism. Assets these designees hold under U.S. jurisdiction are frozen and U.S. persons are prohibited from engaging in transactions in property or interests in property blocked under the order.

For more information on the September 23, 2001 designation of Al Rashid Trust, please visit: http://www.treas.gov/offices/enforcement/key-issues/protecting/charities_execorder_13224-a.shtml#trust.

For more information on the October 14, 2003 designation of Al-Akhtar Trust International, please visit: http://www.treas.gov/press/releases/js899.htm.



TERRORISM AND FINANCIAL INTELLIGENCE

Key Issues

PROTECTING CHARITABLE ORGANIZATIONS

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Complete List of Designations

Additional Background Information on Charities Designated Under Executive Order 13224

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A

Afghan Support Committee

U.S. Designation Date: January 9, 2002

UN Designation Date: January 11, 2002

Background: The Afghan Support Committee (ASC) is a non-governmental organization (NGO) established by Usama bin Laden, based in Afghanistan, and affiliated with the Revival of Islamic Heritage Society (RIHS). Abu Bakr Al-Jaziri, the finance chief of ASC, also served as the head of organized fundraising for UBL. Al-Jaziri collected funds for al Qaida in Jalalabad through the ASC. He also collected money for al Qaida from local Arab NGOs by claiming the funds were for orphans and widows. Al-Jaziri then turned the funds over to al Qaida's finance committee. In 2000, he moved from Jalalabad to Pakistan where he continued to raise and transfer funds for al Qaida.

AKAs: Ahya Ul Turas
Jamiat Ayat-Ur-Rhas Al Islamia
Jamiat Ihya Ul Turath Ul Turath Al Islamia
Lajnat Ul Masa Eidatul Afghani

For Additional Information: http://www.treas.gov/press/releases/po910.htm

Aid Organization of the Ulema

U.S. Designation Date: April 19, 2002

UN Designation Date: April 24, 2002

Background: The Aid Organization of the Ulema (AOU) is based in Pakistan and is a successor organization to Al Rashid Trust, listed by the UN as a financial facilitator of terrorists in September 2001, under UNSCR 1333. Al Rashid Trust was among the first organizations designated as a terrorist financier and facilitator. Al Rashid Trust changed its name to AOU and remains active. AOU is headquartered in Pakistan, and continues to operate offices there. AOU has been raising funds for the Taliban since 1999, and officers of the organization are reported to be representatives and key leaders of al Qaida. This designation captures the re-named office and identifies additional locations of other branch offices in Pakistan.

AKAs: Al Rashid Trust Al Rushed Trust Al-Rushed Trust Al-Rashid Trust

For Additional Information: http://www.treas.gov/press/releases/po3014.htm

Al Akhtar Trust

U.S. Designation Date: October 14, 2003

Background: Al Akhtar Trust is known to have provided support to al Qaida fighters in Afghanistan. Al Akhtar Trust is carrying on the activities of the previously designated Al Rashid Trust (designated September 23, 2001) and is linked to the Taliban and Al Qaida. An associate of Al Akhtar Trust has attempted to raise funds to finance obligatory jihad in Iraq, and it has been reported that a financier of Al Akhtar Trust has been linked to the kidnapping and murder of the Wall Street Journal's South Asia Bureau Chief, Daniel Pearl. The group leader of the terrorist group Jadish-e-Mohammed, Mastoid Zahra, set up two organizations registered in Pakistan as humanitarian aid agencies: Al Akhtar Trust and Elkhart Trust. Jadish-e-Mohammed hoped to give the impression that the two new organizations were separate entities and sought to use them as a way to deliver arms and ammunition to their members under the guise of providing humanitarian aid to refugees and other needy groups. Pakistani newspaper reporting in November 2000 indicated that Al Akhtar Trust was established under the supervision of prominent religious scholars for the purpose of providing financial assistance for mujahideen, financial support to the Taliban and food, clothes, and education to orphans of martyrs. The Chairman and Chief Executive Officer of Al Akhtar Trust is Hakeen Muhammad Akhtar, a Pakistani citizen, who stated that their services for the Taliban and Mullah Omar were known to the world. Al Akhtar Trust was providing a wide range of support to Al-Qaida and Pakistani-based sectarian and jihadi groups, specifically Lashkar-e-Tayyiba, Lashkar-I-Jhangvi, and Jaish-e-Mohammed. All three of these organizations have been designated by the U.S. These efforts included providing financial and logistical support as well as arranging travel for Islamic extremists. This designation covers operations of Al Akhtar Trust through offices and individuals operating outside of Pakistan.

In June 2008, the United States identified new aliases Al Akhtar used to circumvent sanctions so that it could continue to support al Qaida.

AKAs: Al Akhtar Trust
Al-Akhtar Trust International
Akhtarabad Medical Camp
Akhtar Medical Centre
Pakistan Relief Foundation
Pakistani Relief Foundation
Azmat-e-Pakistan Trust
Azmat Pakistan Trust

For Additional Information: http://www.treas.gov/press/releases/js899.htm

For Additional Information about New Aliases:
http://www.ustreas.gov/press/releases/hp1065.htm

Al Aqsa Foundation

U.S. Designation Date: May 29, 2003

Background: Al Aqsa Foundation (AAF) is a critical part of the HAMAS terrorist support infrastructure. Through its headquarters in Germany and branch offices in the Netherlands, Denmark, Belgium, Sweden, Pakistan, South Africa, Yemen and elsewhere, AAF funnels money collected for charitable purposes to HAMAS terrorists. Like other HAMAS-affiliated charities, AAF uses humanitarian relief as cover to provide support to the HAMAS terrorist organization. Mahmoud Amr, the Director of AAF in Germany, is an active figure in HAMAS. AAF offices are included in lists of organizations that contributed to the HAMAS-affiliated Charity Coalition in 2001 and 2002. Pursuant to a July 31, 2002 administrative order, German authorities closed AAF in Germany for supporting HAMAS. In April 2003, Dutch authorities blocked AAF assets in The Netherlands based on information that funds were provided to organizations supporting terrorism in the Middle East. Criminal charges against some AAF officials were also filed. On January 1, 2003, the Danish government charged three AAF officials in Denmark for supporting terrorism. Also, the head of the Yemeni branch of AAF, Shaykh Muhammad Ali Hassan Al-Muayad, was arrested for providing

support to terrorist organizations, including Al-Qaida and HAMAS, in January 2003 by German authorities. In Scandinavia, the Oslo, Norway-based Islamic League used the AAF in Sweden to channel funds from some members of the Islamic community in Oslo, Norway to HAMAS. Al-Muayad has also allegedly provided money, arms, recruits and communication equipment for Al-Qaida. At least until Al-Muayad's arrest, Ali Muqbil, the General Manager of AAF in Yemen and a HAMAS official, transferred funds on Al-Muayad's orders to HAMAS, PIJ or other Palestinian organizations assisting "Palestinian fighters." The disbursements were recorded as contributions for charitable projects. Also, several officials and active supporters of al Qaida and Asbat Al-Ansar (designated under EO 13224 as a specially designated global terrorist) are leaders of some branches of the AAF.

AKAs: Al-Aqsa International Foundation Al-Aqsa Charitable Foundation Sanabil al-Aqsa Charitable Foundation Al-Aqsa Sinabil Establishment Al-Aqsa Charitable Organization Charitable Al-Aqsa Establishment Mu'assa al-Aqsa al-Khayriyya Mu'assa Sanabil Al-Aqsa al- Khayriyya Aqssa Society, Al-Aqsa Islamic Charitable Society Islamic Charitable Society for al-Aqsa Charitable Society to Help the Noble al-Aqsa Nusrat al-Aqsa al-Sharif

For Additional Information: http://www.treas.gov/press/releases/js439.htm

Al Furqan

U.S. Designation Date: May 6, 2004

UN Designation Date: May 11, 2004

Background: Information shows this non-governmental organization was associated with al Qaida, having close ties and sharing an office with the Global Relief Foundation (GRF), and was chiefly sponsored by the Bosnian branch of the Al Haramain Islamic Foundation, with whom it jointly conducted many activities in Bosnia. Individuals working for Al Furqan have been involved in multiple instances of suspicious activity, including surveillance of the U.S. Embassy and UN buildings in Sarajevo. One former Al Furqan employee also has ties to the Algerian Armed Islamic Group (GIA). Although Al Furqan ostensibly ceased operations in 2002, two successor organizations, Sirat and Istikamet, continue to act on behalf of Al Furqan in Bosnia.

AKAs: Dzemilijati Furkan Dzem'ijjetul Furqan Association for Citizens Rights and Resistance to Lies Dzemijetul Furkan Association of Citizens for the Support of Truth and Suppression of Lies Sirat Association for Education Culture and Building Society-Sirat Association for Education Cultural and to Create Society-Sirat Istikamet In Siratel

For Additional Information: http://www.treas.gov/press/releases/js1527.htm

Al-Haramain & Al Masjed Al-Aqsa Charity Foundation

U.S. Designation Date: May 6, 2004

UN Designation Date: June 28, 2004

Background: The Al-Haramain & Al Masjed Al-Aqsa Charity Foundation (AHAMAA) has significant financial ties to the Bosnia-based NGO Al Furqan, and al Qaida financier Wa'el Hamza Julaidan, who was designated by the Treasury Department on September 6, 2002. Wa'el Hamza Julaidan, a Saudi citizen, is a close associate of Usama bin Laden. Julaidan fought with bin Laden in Afghanistan in the 1980s. Bin Laden himself acknowledged his close ties to Julaidan during a 1999 interview with al-Jazeera TV. As a member of the Board of Directors for AHAMAA, Julaidan opened three bank accounts on behalf of the NGO between 1997 and 2001 and continued to have authorization to handle two of their accounts as a signatory on two the NGO's Bosnian accounts.

AKAs: Al Haramain Al Masjed Al Aqsa Al Haramayn Al Masjid Al Aqsa Al-Haramayn and Al Masjid Al Aqsa Charitable Foundation

For Additional Information: http://www.treas.gov/press/releases/js1527.htm

Al Haramain Islamic Foundation-related Designations:

- Al Haramain Islamic Foundation (general background information)
- Al Haramain Islamic Foundation – All Offices
- Afghanistan
- Albania
- Bangladesh
- Bosnia
- Comoros Islands
- Ethiopia
- Indonesia
- Kenya
- The Netherlands
- Pakistan
- Somalia
- Tanzania
- United States

Al Haramain Islamic Foundation

General Background: Al-Haramain Islamic Foundation (AHF) represents itself as a private, charitable, and educational organization dedicated to promoting Islamic teaching throughout the world. It is one of the principal Islamic non-governmental organizations active throughout the world. Funding generally comes from grants from other countries, individual Muslim benefactors, and special campaigns, which selectively target Muslim-owned business entities around the world as sources of donations.

There is evidence that field offices and representatives operating throughout Africa, Asia and Europe have provided financial and logistical support to the al Qaida network and other terrorist organizations designated by the United States, and, in some cases, included on the UN 1267 Committee's consolidated list of individuals/entities subject to Security Council Sanctions. Some of these organizations include the Egyptian Islamic Jihad (EIJ), Jemaah Islamiyah, Al-Ittihad Al-Islamiya (AIAI), Lashkar E-Taibah, and HAMAS – all of which are designated terrorist organizations and all of which have received funds from AHF, its branches, or local intermediaries.

Al Haramain - Afghanistan

Saudi/U.S. Designation Date: June 2, 2004

UN Designation Date: June 6, 2004

Background: In Afghanistan, prior to the removal of the Taliban from power, AHF supported the cause of Jihad and was linked to the UBL financed Makhtab al-Khidemat (MK), a pre-cursor organization of al Qaida and a Specially Designated Global Terrorist pursuant to the authorities of E.O. 13224.

Following the September 11, 2001 terrorist attacks, AHF activities supporting terrorism in Afghanistan continued. In 2002, activities included involvement with a group of persons trained to attack foreigners in Afghanistan. A journalist suspected of meeting with al Qaida and Taliban members in Afghanistan was reportedly transferring funds on behalf of the al Qaida-affiliated AHF and forwarding videotapes from al Qaida leaders to an Arabic language TV network for broadcast.

For Additional Information: http://www.treas.gov/press/releases/js1703.htm

Al Haramain - Albania

Saudi/U.S. Designation Date: June 2, 2004

UN Designation Date: June 6, 2004

The U.S. has information that indicates UBL may have financed the establishment of AHF in

Albania, which has been used as cover for terrorist activity in Albania and in Europe. In late 2000, a close associate of a UBL operative moved to Albania and was running an unnamed AHF subsidiary. In 1998, the head of Egyptian Islamic Jihad in Albania was reportedly also a financial official for AHF in Albania. This individual, Ahmed Ibrahim al-Nagar, was reportedly extradited from Albania to Egypt in 1998. At his trial in Egypt, al-Nager reportedly voiced his support for UBL and al Qaida's August 1998 terrorist attacks against the U.S. embassies in Kenya and Tanzania.

Salih Tivari, a senior official of the moderate Albanian Muslim community, was murdered in January 2002. Ermir Gjinishi, who had been supported by AHF, was detained in connection with the murder, but no charges were filed; he was later released by Albanian authorities. Just prior to being murdered, Tivari informed the AHF-affiliated Gjinishi that he intended to reduce "foreign Islamic influence" in the Albanian Muslim community.

Prior to his murder, Tivari controlled finances, personnel decisions, and donations within the Albanian Muslim community. This provided him significant power, enabling him to survive several attempts by extremists trained overseas to replace him or usurp his power.

As of late 2003, AHF was paying for, through a HAMAS member with close ties to AHF in Albania, security personnel to guard the AHF building in Albania, which had been shut down earlier in 2003.

For Additional Information: http://www.treas.gov/press/releases/js1703.htm

Al Haramain - Bangladesh

Saudi/U.S. Designation Date: June 2, 2004

UN Designation Date: June 6, 2004

Background: Information available to the U.S. shows that a senior AHF official deployed a Bangladeshi national to conduct surveillance on U.S. consulates in India for potential terrorist attacks. The Bangladeshi national was arrested in early 1999 in India, reportedly carrying four pounds of explosives and five detonators. The terrorist suspect told police that he intended to attack U.S. diplomatic missions in India. The suspect reportedly confessed to training in al Qaida terrorist camps in Afghanistan, where he met personally with Usama bin Laden in 1994. The suspect first heard of plans for these attacks at the AHF office in Bangladesh.

For Additional Information: http://www.treas.gov/press/releases/js1703.htm

Al Haramain Islamic Foundation (Vazir a/k/a) - Bosnia

Saudi/U.S. Designation Date: March 11, 2002
Amended December 22, 2003

UN Designation Date: March 13, 2002
Amended December 26, 2003

Background: The Bosnia office of Al Haramain is linked to Al-Gama'at al-Islamiyya, an Egyptian terrorist group (designated under Executive Order 13224 on October 31, 2001) that was a signatory to UBL's February 23, 1998 fatwa against the United States. After the Bosnia branch of Al Haramain was designated in March 2002, Al Haramain officials closed its Bosnian operations. Officials in Bosnia then persuaded senior Al Haramain officials to reopen the organization under a different name in Travnik, Bosnia. The new non-governmental organization, Vazir, was founded in May 2003 and established its headquarters in a business space formerly used by Al Haramain. The Ministry of Justice and Administration for the Central Bosnian canton registered Vazir on June 11, 2003, as an association for sport, culture, and education. The office opened under the name Vazir in early August 2003. The original designation of the Bosnian branch of Al Haramain was amended to add the aka, "Vazir," resulting in the formal designation of Vazir on December 22, 2003.

For Additional Information: http://www.treas.gov/press/releases/po1086.htm

Al Haramain Islamic Foundation – Comoros Islands

U.S. Designation Date: September 9, 2004

UN Designation Date: September 28, 2004

Background: Al Haramain had operations throughout the Union of the Comoros, and information shows that associates of AHF Comoros are linked to al Qaida. According to the transcript of U.S. v. Bin Laden, the Union of the Comoros was used as a staging area and exfiltration route for the perpetrators of the 1998 bombings of the U.S. embassies in Kenya and Tanzania. The AHF branches in Kenya and Tanzania have been previously designated for providing financial and other operational support to these terrorist attacks.

For Additional Information: http://www.treas.gov/press/releases/js1895.htm

Al Haramain - Ethiopia

Saudi/U.S. Designation Date: June 2, 2004

UN Designation Date: June 6, 2004

Background: Information available to the U.S. shows that AHF in Ethiopia has provided support to Al-Ittihad Al-Islamiya (AIAI). In Ethiopia, AIAI has engaged in attacks against Ethiopian defense forces. AIAI has been designated both by the U.S. Government and by the UN 1267 Sanctions Committee. Ethiopia is one of the countries where AHF's website states that they have operations, but there does not appear to be a formal branch office. As part of our efforts to designate this branch, we have asked that action be taken to ensure that individuals cannot use the name of AHF or act under its auspices within, or in connection with services provided in, Ethiopia.

For Additional Information: http://www.treas.gov/press/releases/js1703.htm

Al Haramain Islamic Foundation - Indonesia

U.S. Designation Date: January 22, 2004

UN Designation Date: January 26, 2004

Background: In 2002, money purportedly donated by the Al Haramain Islamic Foundation (AHF) for humanitarian purposes to non-profit organizations in Indonesia was possibly diverted for weapons procurement, with the full knowledge of AHF in Indonesia. Using a variety of means, AHF has provided financial support to al Qaida operatives in Indonesia and to the terrorist group Jemaah Islamiyah (JI). According to Omar al-Faruq, a senior al Qaida official apprehended in Southeast Asia, AHF was one of the primary sources of funding for al Qaida network activities in the region. The U.S. has designated JI, and the 1267 Committee has included it on its list, because of its ties to al Qaida. JI has committed a series of terrorist attacks, including the bombing of a nightclub in Bali on October 12, 2002 that killed 202 people and wounded over 300 additional people.

AKA: Yayasan Al-Manahil-Indonesia

For Additional Information: http://www.treas.gov/press/releases/js1108.htm

Al Haramain Islamic Foundation - Kenya and Tanzania

U.S. Designation Date: January 22, 2004

UN Designation Date: January 26, 2004

Background: Al Haramain Islamic Foundation offices in Kenya and Tanzania provide

support, or act for or on behalf of, Al-Itihaad al-Islamiya (AIAI) and al Qaida. AIAI shares ideological, financial and training links with al Qaida and financial links with several NGOs and companies, including AHF, which is used to transfer funds. AIAI also has invested in the "legitimate" business activities of AHF.

As early as 1997, U.S. and other friendly authorities were informed that the Kenyan branch of AHF was involved in plotting terrorist attacks against Americans. As a result, a number of individuals connected to AHF in Kenya were arrested and later deported by Kenyan authorities. In August 1997, an AHF employee indicated that the planned attack against the U.S. Embassy in Nairobi would be a suicide bombing carried out by crashing a vehicle into the gate at the Embassy. A wealthy AHF official outside East Africa agreed to provide the necessary funds. Also in 1997, AHF senior leaders in Nairobi decided to alter their (then) previous plans to bomb the U.S. Embassy in Nairobi and instead sought to assassinate U.S. citizens. During this time period, an AHF official indicated he had obtained five hand grenades and seven "bazookas' from a source in Somalia. According to information available to the U.S., these weapons were to be used in a possible assassination attempt against a U.S. official. A former Tanzanian AHF Director was believed to be associated with UBL and was responsible for making preparations for the advance party that planned the August 7, 1998, bombings of the U.S. Embassies in Dar Es Salaam, Tanzania, and Nairobi, Kenya. As a result of these attacks, 224 people were killed.

Shortly before the dual-Embassy bombing attacks in Kenya and Tanzania, a former AHF official in Tanzania met with another conspirator to the attacks and cautioned the individual against disclosing knowledge of preparations for the attacks. Around the same time, four individuals led by an AHF official were arrested in Europe. At that time, they admitted maintaining close ties with two terrorist groups, Egyptian Islamic Jihad (EIJ) and Gamma Islamiyah. In early 2003, individuals affiliated with AHF in Tanzania discussed the status of plans for an attack against several hotels in Zanzibar. The scheduled attacks did not take place due to increased security by local authorities, but planning for the attacks remained active.

For Additional Information: http://www.treas.gov/press/releases/js1108.htm

Al Haramain - The Netherlands

Saudi/U.S. Designation Date: June 2, 2004

UN Designation Date: June 6, 2004

Background: Since 2001, Dutch officials have confirmed that the Al Haramain Humanitarian Aid Foundation located in Amsterdam is part of the larger Al Haramain Islamic Foundation network and that Aqeel Abdul Aziz Al-Aqil, who has also been designated by the United States and the UN 1267 Sanctions Committee because of AHF's support for al Qaida while under his oversight, is chairman of this foundation's board of directors. As noted elsewhere in this document, AHF was the founder and leader of AHF and was responsible for all of its activities, including its support of terrorism.

AKA: Stichting Al Haramain Humanitarian Aid

For Additional Information: http://www.treas.gov/press/releases/js1703.htm

Al Haramain Islamic Foundation - Pakistan

Saudi/U.S. Designation Date: March 11, 2002

UN Designation Date: March 13, 2002

Background: Before the removal of the Taliban from power in Afghanistan, the Al Haramain Islamic Foundation in Pakistan (AHF-Pakistan) supported the Taliban and other groups. AHF-Pakistan is also linked to the UBL-financed and designated terrorist organization, Makhtab al-Khidemat (MK). At least two former AHF-Pakistan employees are suspected of having al Qaida ties, and another AHF-Pakistan employee is suspected of financing al Qaida operations. Another former AHF employee in Islamabad was identified as an alleged al- Qaida member who reportedly planned to carry out several devastating terrorist operations in the United States. In January 2001, extremists with ties to individuals

associated with a fugitive UBL lieutenant were indirectly involved with AHF-Pakistan. As of late 2002, a senior member of AHF in Pakistan, who has also been identified as a "bin Laden facilitator," reportedly operated a human smuggling ring to facilitate travel of al Qaida members and their families out of Afghanistan to various other countries. AHF in Pakistan also supports the designated terrorist organization, Lashkar E-Taibah (LET). Some time in 2000, an AHF representative in Karachi, Pakistan met with Zelinkhan Yandarbiev. The U.S. has designated Yandarbiev, and the UN 1267 Committee has included him on its list because of his connections to al Qaida. The AHF representative and Yandarbiev reportedly resolved the issue of delivery to Chechnya of Zenit missiles, sting anti-aircraft missiles, and hand-held anti-tank weapons.

For Additional Information: http://www.treasury.gov/press/releases/po1086.htm

Al Haramain Islamic Foundation - Somalia

Saudi/U.S. Designation Date: March 11, 2002

UN Designation Date: March 13, 2002

Background: The Saudi-based Al Haramain Islamic Foundation is a private, charitable and educational organization dedicated to promoting Islamic teachings throughout the world. The Somalia office, however is linked to Usama bin Laden's al Qaida network and Al-Itihaad al-Islamiyya (AIAI), a Somali terrorist group (designated under Executive Order 13224 on September 23, 2001). Al Haramain Somalia employed AIAI members and provided them with salaries through al Barakaat Bank (designated under Executive Order 13224 on November 7, 2001), which was a primary source of terrorist funding. Al Haramain Somalia continued to provide material and financial support for AIAI even after the group's designation under E.O. 13224 and UNSCR 1333. Money was funneled to AIAI by disguising funds as if they were intended for orphanage projects or Islamic schools.

For Additional Information: http://www.treas.gov/press/releases/po1086.htm

Al Haramain Islamic Foundation - United States

U.S. Designation Date: September 9, 2004

UN Designation Date: September 28, 2004

The U.S.-based branch of AHF was formally established in 1997. Documents naming Suliman Al-Buthe as the organization's attorney and providing him with broad legal authority were signed by Aqeel Abdul Aziz Al-Aqil, the former director of AHF. Aqil has been designated by the United States and the UN 1267 Sanctions Committee because of AHF's support for al Qaida while under his oversight, and Al-Buthe has also been designated by the United States and the UN 1267 Sanctions Committee. The assets of the U.S. AHF branch, which is headquartered in Oregon, were originally blocked pending investigation on February 19, 2004. An affidavit in support of a search warrant by other federal agencies also alleged that the U.S. branch of AHF criminally violated tax laws and engaged in other money laundering offenses. Information showed that individuals associated with the branch tried to conceal the movement of funds intended for Chechnya by omitting them from tax returns and mischaracterizing their use, which they claimed was for the purchase of a prayer house in Springfield, Missouri. The U.S.-based branch of AHF was fully designated under E.O. 13224 on September 9, 2004, and under UNSCR 1267 on September 28, 2004.

For Additional Information: http://www.treas.gov/press/releases/js1895.htm

Al Haramain Islamic Foundation – All Offices

U.S. Designation Date: June 19, 2008

General Background: Evidence demonstrates that the AHF organization was involved in providing financial and logistical support to the al Qaida network and other terrorist organizations designated by the United States and the United Nations. Between 2002-2004, the United States designated thirteen AHF branch offices operating in Afghanistan, Albania, Bangladesh, Bosnia & Herzegovina, Comoros Islands, Ethiopia, Indonesia, Kenya, Netherlands, Pakistan, Somalia, Tanzania, and the United States. The Kingdom of Saudi

Arabia joined the United States in designating several branch offices of AHF and, due to actions by Saudi authorities, AHF has largely been precluded from operating in its own name. Despite these efforts, AHF leadership has attempted to reconstitute the operations of the organization, and parts of the organization have continued to operate. In 2008, the U.S. Government designated the entirety of the AHF organization, including its headquarters in Saudi Arabia.

For Additional Information: http://www.ustreas.gov/press/releases/hp1043.htm

Al Rashid Trust

U.S. Designation Date: September 23, 2001

UN Designation Date: October 6, 2001

Background: When President Bush initiated the financial war on terrorism in September 2001, the Al Rashid Trust was among the first organizations named as a financial facilitator of terrorists. This organization had been raising funds for the Taliban since 1999. The Al Rashid Trust is a group that funded al Qaida and the Taliban and is also closely linked to the al Qaida-associated Jaish Mohammed terrorist group. Al Rashid has been directly linked to the January 2002 abduction and subsequent murder of Wall Street Journal reporter Daniel Pearl in Pakistan. Al Rashid and other fronts and groups have used a British internet site called the Global Jihad Fund, which openly associates itself with Usama bin Laden, to publish bank account information and solicit support to facilitate the growth of various jihad movements around the world by supplying them with funds to purchase their weapons. See also Aid Organization of the Ulema.
In July 2008, the United States identified new aliases Al Rashid used to circumvent sanctions so that it could continue to support al Qaida.

AKAs: Al Amin Welfare Trust
Al Amin Trust
Al Ameen Trust
Al-Ameen Trust
Al Madina Trust
Al-Madina Trust

For Additional Information: http://www.whitehouse.gov/news/releases/2001/09/20010924-1.html

For Additional Information about New Aliases:
http://www.ustreas.gov/press/releases/hp1065.htm

Al Salah Society (Palestinian territories)

U.S. Designation Date: August 7, 2007

Background: Al-Salah Society is one of the largest and best-funded Hamas charitable organizations in the Palestinian territories. Al-Salah Society's director, Ahmad Al-Kurd, was also designated on this date. The Al-Salah Society supported Hamas-affiliated combatants during the first Intifada and recruited and indoctrinated youth to support Hamas's activities. The Al-Salah Society has received substantial funding from Persian Gulf countries, including at least hundreds of thousands of dollars from Kuwaiti donors, and it has employed a number of Hamas military wing members. The Al-Salah Society was included on a list of suspected Hamas and Palestinian Islamic Jihad-affiliated NGOs whose accounts were frozen by the Palestinian Authority as of late August 2003. After freezing the bank accounts, PA officials confirmed that the Al-Salah Society was a front for Hamas.

AKAs:
Al-Salah Association
Al-Salah Islamic Foundation
Al-Salah
Al-Salah Islamic Society
Al-Salah Islamic Association
Al-Salah Islamic Committee
Al-Salah Organization
Islamic Salah Foundation
Islamic Salah Society

Islamic Salvation Society
Islamic Righteous Society
Islamic Al-Salah Society
Jamiat Al-Salah Society
Jamiat al-Salah al-Islamiya
Jami'at al-Salah al-Islami
Jami'a al-Salah
Jammeat El-Salah
Salah Islamic Association
Salah Welfare Organization
Salah Charitable Association

For Addition information: http://www.treas.gov/press/releases/hp531.htm

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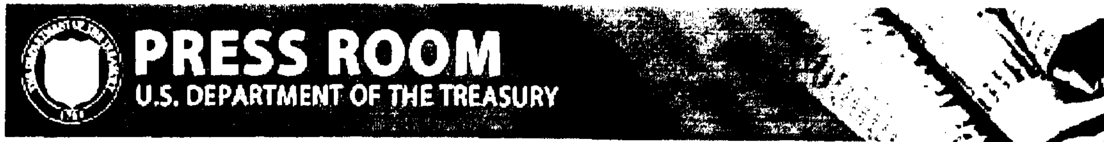
Last Updated: July 17, 2008



FROM THE OFFICE OF PUBLIC AFFAIRS

October 14, 2003
JS-899

U.S. DESIGNATES AL AKHTAR TRUST
Pakistani Based Charity is Suspected of
Raising Money for Terrorists in Iraq

WASHINGTON – The U.S. Treasury Department today announced that it is designating Al Akhtar Trust as a terrorist support organization under Executive Order 13224 and will be requesting that the United Nations list the organization as a terrorist support group. Today's designation freezes any assets of Al Akhtar Trust within the U.S. and prohibits transactions with U.S. nationals. The UN listing will require that all UN Member States take similar actions.

"Today's designation strikes at the life blood of terrorists -- the money that funds them," Secretary of the Treasury John Snow stated. "Shutting down this organization will cripple yet another source of support for terrorists and possibly help undermine the financial backing of terrorists staging attacks against American troops and Iraqi civilians in Iraq. The activities of Al Akhtar Trust demonstrate the dangerous alliance between corrupted charities and terrorists. There is little more despicable than raising money under the guise of doing good and instead diverting the resources of often well-intentioned donors to supporting acts of terror."

Al Akhtar Trust is a Pakistani based charity known to have provided support to al-Qaida fighters in Afghanistan. Al Akhtar is carrying on the activities of the previously designated Al Rashid Trust. The organization is also suspected of raising money for jihad in Iraq and is connected to an individual with ties to the kidnapping and murder of Wall Street Journal Reporter Daniel Pearl. This designation builds on ongoing counter-terrorism cooperation with the Pakistani government and comes on the heels of Secretary Snow's recent visit to Islamabad.

With today's designation, the U.S. and our international partners have designated 321 individuals and organizations as terrorists and terrorist supporters and have frozen over $136.8 million in terrorist assets and have seized more than $60 million.

A fact sheet providing more details on today's designation is attached.

FACT SHEET
AL AKHTAR TRUST INTERNATIONAL
INTRODUCTION

Al Akhtar Trust International is linked to the following persons/entities designated by the U.S. under Executive Order 13224: the Taliban and Al Qaida and Al- Rashid Trust, among others. An associate of Al Akhtar Trust has attempted to raise funds to finance obligatory jihad in Iraq, and it has been reported that a financier of Al Akhtar Trust has been linked to the kidnapping and murder of the Wall Street Journal's South Asia Bureau Chief, Daniel Pearl.

IDENTIFIER INFORMATION

AL AKHTAR TRUST
AL-AKHTAR TRUST INTERNATIONAL

- ST -1/A, Gulsahn-E-Iqbal, Block 2, Karachi 25300, Pakistan
- Al-Akhtar Medical Centre, Gulistan-E-Jauhar, Block 12, Karachi, Pakistan
- Regional Offices in Pakistan: Bawalnagar, Bahawalpur, Gilgit, Islamabad, Mirpur Khas, and Tando-Jan-Muhammad
- Akhtarabad Medical Camp, Spin Boldak, Afghanistan

BACKGROUND INFORMATION

According to information available to the U.S. government, following the house arrest of the group leader of Jaish-e-Mohammed, Masoud Azhar, Jaish-e-Mohammed members set up two organizations registered in Pakistan as humanitarian aid agencies: AL AKHTAR TRUST and Alkhair Trust. Jaish-e-Mohammed hoped to give the impression that the two new organizations were separate entities and sought to use them as a way to deliver arms and ammunition to their members under the guise of providing humanitarian aid to refugees and other needy groups. (Jaish-e-Mohammed was designated by the U.S. on October 12, 2001 and by the UN 1267 Sanctions Committee on October 17, 2001).

Pakistani newspaper reporting in November 2000 indicated that AL AKHTAR TRUST INTERNATIONAL was established under the supervision of prominent religious scholars for the purpose of providing financial assistance for mujahideen, financial support to the Taliban and food, clothes, and education to orphans of martyrs. (The Taliban has been designated by the US and UN.) At a ceremony in Islamabad celebrating the establishment of the Trust, the Information Secretary of Harkatul Mujahideen, Maulana Allah Wasaya Qasim, termed the establishment of AL AKHTAR TRUST as "commendable" and stated that religious scholars should have entered the field earlier. (Harkatul Mujahideen was designated by the U.S. on September 23, 2001 and by the UN 1267 Sanctions Committee on October 6, 2001.) There was an appeal to the people to support generously the AL AKHTAR TRUST.

According to information available to the U.S. Government, the Chairman and Chief Executive of AL AKHTAR TRUST is Hakeem Muhammad Akhtar, a Pakistani citizen. When asked about his services in Afghanistan and his special relations with Mullah Omar, Supreme Commander of the Taliban, Akhtar stated that their services for the Taliban and Mullah Omar were known to the world. (Mullah Omar, aka Mohammed Omar, has been designated by the U.S. and the UN 1267 Sanctions Committee.

Operation Enduring Freedom, the military phase of the war against terrorism, began on October 7, 2001. The U.S. government has information that, as of mid-November 2001, the AL AKHTAR TRUST was secretly treating wounded Al Qaida members at the medical centers it was operating in Afghanistan and Pakistan. (Al Qaida has been designated by both the U.S. and UN 1267 Sanctions Committee).

During a custodial interview in early 2003, a senior Al Qaida detainee related that AL AKHTAR TRUST and Al-Rashid Trust were the primary relief agencies that Al Qaida used to move supplies into Qandahar, Afghanistan. This detainee was aware of one shipment, in 2001, arranged by an Al Qaida operative that included a "room full" of cartons. The detainee was not aware of the contents of the cartons, but believed that either Al-Rashid Trust or AL AKHTAR TRUST was used for the shipment.

In 2002, Al-Rashid Trust and AL AKHTAR TRUST decided to start a drive to collect donations from the business/industrial circles of Pakistan. Mullah Izatullah, an Al Qaida official living in Chaman, Pakistan, was associated with both Al-Rashid Trust and AL AKHTAR TRUST. Al-Rashid Trust was designated by the U.S. on September 23, 2001 and by the UN 1267 Sanctions Committee on October 6, 2001. Information in the possession of the U.S. Government indicates that, as of mid-March 2002, AL AKHTAR TRUST was conducting all activities of the former Al-Rashid Trust.

During a custodial interview in mid-April 2003, a senior Al Qaida detainee stated that Al-Rashid Trust and AL AKHTAR TRUST provided donations to Al Qaida. While Al Qaida was based in Qandahar, Afghanistan, these organizations provided donations in the form of blankets and clothing to Al Qaida members. When Al Qaida members fled from Qandahar in late 2001, these organizations provided the families of Al Qaida members with financial assistance.

AL AKHTAR TRUST was providing a wide range of support to Al-Qaida and Pakistani based sectarian and jihadi groups, specifically Lashkar-e- Tayyiba, Lashkar-I-Jhangvi, and Jaish-e-Mohammed. (All three of these organizations have been designated by the U.S.) These efforts included providing financial and logistical support as well as arranging travel for Islamic extremists.

According to information available to the U.S. Government from March 2003, an associate of AL AKHTAR TRUST was attempting to raise funds in order to finance "obligatory jihad" in Iraq (i.e., because fatwas had been issued, Muslims were obligated to support jihad in Iraq). Donors were told they could contact AL AKHTAR TRUST via email for additional information.

A financier of AL AKHTAR TRUST is also reported to have ties to the kidnapping and murder of the Wall Street Journal's South Asia Bureau. Chief, Daniel Pearl. According to an article appearing in the Wall Street Journal, on or about January 31 or February 1, 2002, citing Pakistani police, a man named Saud Memon drove into the compound where Daniel Pearl was being held, along with three Arabic-speaking men. The compound was owned by Mr. Memon, a garment manufacturer, and was located in the northern outskirts of Karachi, Pakistan. Eventually, the three Arabic-speaking men, along with one of Mr. Memon's employees, were left alone with Daniel Pearl in one room of the compound. One of these men turned on a video camera, and another asked Mr. Pearl questions about his religious background. After the videotaped statement by Mr. Pearl, he was blindfolded and killed.

Shortly after the murder, Pakistani police sealed Mr. Memon's home in Karachi, which also contained his garment business. Mr. Memon remains one of the key figures still at large in the Pearl slaying. Photos of him along with other alleged conspirators have been published throughout Pakistan, and a reward has been offered for information leading to their arrest.

According to the article, Mr. Memon is a known financier for militant groups in association with the Al-Rashid Trust, which is described in the article as having changed its name to Al AKHTAR TRUST. According to information available to the U.S. government, an individual by the name of Al-Saud Memon is the individual primarily responsible for the AL AKHTAR TRUST's finances and the direction of financial resources and support for the Trust.

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July 3, 2008
HP-1066

Week 10 Wrap-Up: Treasury Sent 10.025 Million Stimulus Payments This Week

This week the Treasury Department sent out 10.025 million economic stimulus payments to American households totaling $7.775 billion. So far, Treasury has sent out 104.875 million total economic stimulus payments totaling $86.079 billion.

Cumulative Total

Total Number of Payments: 104.875 million
Total Amount of Payments: $86.079 billion

Week Ten (June 30-July 4)

Total Number of Payments: 10.025 million
Total Amount of Payments: $7.775 billion

Week Nine (June 23-27)

Total Number of Payments: 9.674 million
Total Amount of Payments: $7.522 billion

Week Eight (June 16-20)

Total Number of Payments: 9.071 million
Total Amount of Payments: $6.919 billion

Week Seven (June 9-13)

Total Number of Payments: 9.526 million
Total Amount of Payments: $7.032 billion

Week Six (June 2-6)

Total Number of Payments: 9.143 million
Total Amount of Payments: $6.789 billion

Week Five (May 26-30)

Total Number of Payments: 5.757 million
Total Amount of Payments: $4.320 billion

Week Four (May 19-23)

Total Number of Payments: 6.211 million
Total Amount of Payments: $4.927 billion

Week Three (May 12-16)

Total Number of Payments: 15.575 million
Total Amount of Payments: $13.562 billion

Week Two (May 5-9)

Total Number of Payments: 22.180 million
Total Amount of Payments: $20.138 billion

Week One (April 28-May 2)

Total Number of Payments: 7.708 million
Total Amount of Payments: $7.091 billion

The Treasury Department will announce at the end of every week the total number of payments that have been sent to households, and the total amount of payments sent. Payments began April 28 and will continue via direct deposit or paper check through mid-July. For a single filer, the minimum payment is generally $300 and the maximum payment is $600. For joint filers, the minimum is generally $600 and the maximum $1,200. There is also an additional $300 payment for each qualifying child.

For tax returns processed by the Internal Revenue Service by April 15 households will receive their payments according to the last two digits of the Social Security number on the tax form. On a joint return, the first number listed will determine when a stimulus payment will be sent.

A small percent of tax returns will require additional time to process and to compute a stimulus payment amount. For these returns, stimulus payments may not be issued in accordance with the schedule above, even if the tax return was processed by April 15. In these cases, the stimulus payment will be issued approximately 2 weeks after the tax return is ultimately processed.

- 30 -

LINKS

- Direct Deposit Payments

Direct Deposit Payments

If the last two digits of your Social Security number are:	Your economic stimulus payment deposit should be transmitted to your bank account by:
00-20	May 2
21-75	May 9
76-99	May 16

Paper Check

If the last two digits of your Social Security number are:	Your check should be in the mail by:
00-09	May 16
10-18	May 23
19-25	May 30
26-38	June 6
39-51	June 13
52-63	June 20
64-75	June 27
76-87	July 4
88-99	July 11

A small percent of tax returns will require additional time to process and to compute a stimulus payment amount. For these returns, stimulus payments may not be issued in accordance with the schedule above, even if the tax return was processed by April 15. In these cases, the stimulus payment will be issued approximately 2 weeks after the tax return is ultimately processed.

July 3, 2008
HP-1067

Treasury Economic Update 7.3.08

UPDATE 7.3.08

"Today's employment data reflect the impact of the headwinds we face from high energy prices, the housing correction, and the credit disruption. The rebate checks and investment incentives in the stimulus package are helping to support spending while adjustments continue in housing and financial markets."

Assistant Secretary Phillip Swagel, July 3, 2008

Employment Fell in June:
Job Growth: Payroll employment fell by 62,000 in June, following a decrease of 62,000 in May. The United States has added about 7.8 million jobs since August 2003. Employment increased in 35 states and the District of Columbia over the year ending in May. (Last updated: July 3, 2008)
Unemployment: The unemployment rate was 5.5 percent in June, unchanged from May. (Last updated: July 3, 2008)

Signs of Economic Strength Include Exports and Low Inflation:
Exports: Strong global growth is boosting U.S. exports, which grew by 9.5 percent over the past 4 quarters. (Last updated: June 26, 2008)
Inflation: Core inflation remains contained. The consumer price index excluding food and energy rose 2.3 percent over the 12 months ending in May. (Last updated: June 13, 2008)

The Economic Stimulus Package Will Provide a Temporary Boost to Our Economy:
The package will help our economy weather the housing correction and other challenges. The Economic Stimulus Act of 2008, signed into law by President Bush has two main elements--stimulus payments so that working Americans have more money to spend and temporary tax incentives for businesses to invest and grow. Together, the legislation will provide about $150 billion of stimulus for the economy in 2008, providing a meaningful boost to the U.S. economy in 2008. (Last updated: February 29, 2008)

Pro-Growth Policies Will Enhance Long-Term U.S. Economic Strength:
We are on track to make significant further progress on the deficit. The FY07 budget deficit was down to 1.2 percent of GDP, from 1.9 percent in FY06. Much of the improvement in the deficit reflects strong revenue growth, which in turn reflects strong economic growth. Looking ahead, higher spending on entitlement programs dominates the future fiscal situation; we must squarely face up to the challenge of reforming these programs.

www.treas.gov/economic-plan

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Printer Friendly Version of the U.S. Economic Strength

The U.S. economy is fundamentally strong, but the housing correction, credit turmoil, and high oil prices are weighing on growth this year and short-term risks are to the downside. The Economic Stimulus Act of 2008, signed into law on February 13, will help protect the strength of our economy as we weather the housing downturn and other challenges. This agreement includes short-term incentives to bolster business investment and consumer spending to keep our economy growing and creating jobs this year.

LATEST NEWS

Treasury Releases Fifth in a Series of Social Security Papers

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Economic Growth Package

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- Paulson Remarks on the Economic Stimulus Package
- Fact Sheet: State-by-State Benefit of the Economic Stimulus Act of 2008
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Treasury Releases Social Security Papers

To build on the discussions that Secretary Paulson has had with

search

"Today's employment data reflect impact of the headwinds we face high energy prices, the housing correction, and the credit disruptic The rebate checks and investmer incentives in the stimulus packag helping to support spending while adjustments continue in housing a financial markets."

Assistant Secretary Phillip Swage
July 3, 2008

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- The White House Economy ar Budget
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members of Congress in both parties, Treasury will release a series of issue briefs that will discuss Social Security reform, focusing on the nature of the problem and those aspects of reform that have broad support.

- Paulson Statement on Treasury Social Security Papers on Common Ground
- **Issue Brief 1:** Social Security Reform: The Nature of the Problem
- **Issue Brief 2:** Social Security Reform: A Framework for Analysis
- **Issue Brief 3:** Social Security Reform: Benchmarks for Assessing Fairness and Benefit Adequacy
- **Issue Brief 4:** Social Security Reform: Mechanisms for Achieving True Pre-Funding
- **Issue Brief 5:** Treasury Releases Fifth in a Series of Social Security Papers

U.S. Economic Strength

Employment Fell in June:
Job Growth: Payroll employment fell by 62,000 in June, following a decrease of 62,000 in May. The United States has added about 7.8 million jobs since August 2003. Employment increased in 33 states and the District of Columbia over the year ending in June. *(Last updated: July 18, 2008)*
Unemployment: The unemployment rate was 5.5 percent in June, unchanged from May. *(Last updated: July 3, 2008)*

Signs of Economic Strength Include Exports and Low Inflation:
Exports: Strong global growth is boosting U.S. exports, which grew by 9.5 percent over the past 4 quarters. *(Last updated: June 26, 2008)*
Inflation: Core inflation remains contained. The consumer price index excluding food and energy rose 2.4 percent over the 12 months ending in June. *(Last updated: July 16, 2008)*

The Economic Stimulus Package Will Provide a Temporary Boost to Our Economy:
The package will help our economy weather the housing correction and other challenges. The Economic Stimulus Act of 2008, signed into law by President Bush has two main elements—stimulus payments so that working Americans have more money to spend and temporary tax incentives for businesses to invest and grow. Together, the legislation will provide about $150 billion of stimulus for the economy in 2008, providing a meaningful boost to the U.S. economy in 2008. *(Last updated: February 29, 2008)*

Pro-Growth Policies Will Enhance Long-Term U.S. Economic Strength:
We are on track to make significant further progress on the deficit. The FY07 budget deficit was down to 1.2 percent of GDP, from 1.9 percent in FY06. Much of the improvement in the deficit reflects strong revenue growth, which in turn reflects strong economic growth. Looking ahead, higher spending on entitlement programs dominates the future fiscal situation; we must squarely face up to the challenge of reforming these programs.

Last Updated: July 18, 2008

July 7, 2008
hp-1068

Statement by U.S. Treasury Secretary Henry M. Paulson, Jr. On the SEC, Federal Reserve Memorandum of Understanding

Washington- *Treasury Secretary Henry M. Paulson, Jr. made the following statement today regarding the memorandum of understanding on information sharing and cooperation between the Securities and Exchange Commission and the Federal Reserve.*

"The MOU finalized between the SEC and the Federal Reserve is consistent with the long-term vision of Treasury's Blueprint for a Modernized Regulatory Structure and should help inform future decisions as our Congress considers how to modernize and improve our regulatory structure."

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July 7, 2008
hp-1069

Treasury Will Consult on Baseline Survey of Adult Financial Literacy

Washington – The Treasury Department announced a new research initiative today to examine financial literacy among U.S. adults and how they fare in handling their finances. The study, conducted with the Financial Industry Regulatory Authority Investor Education Foundation, is the first of its kind to focus on adult consumers at both state and national levels.

The President's Advisory Council on Financial Literacy recommended that the Department consult on the project during the Council's February 2008 meeting. Preliminary survey data is expected to be released to researchers and the general public in early 2009.

"The field of financial education in America is in its adolescence. By learning what Americans know, think and feel about money we can better help them, while moving our nation's financial education efforts toward maturity," said Dan Iannicola, Jr., Deputy Assistant Secretary for Financial Education and executive director of the President's Advisory Council. "Equipping Americans to make good financial decisions is always important, but in challenging economic times it matters even more."

The FINRA Investor Education Foundation – the largest foundation dedicated to investor education – will design, fund and conduct the survey, with input from Treasury. Survey working group partners include Dartmouth College Professor Annamaria Lusardi and a team from Applied Research and Consulting, the Employee Benefit Research Institute and the American Institute of Certified Public Accountants.

"We look forward to consulting with Treasury on this inaugural national survey," said Mary Schapiro, a member of the President's Advisory Council on Financial Literacy who is also Chairman of the Financial Industry Regulatory Authority Foundation and CEO of FINRA. "The survey will be unique in its scale and in its focus on the combined effect of knowledge, skills and attitudes on the behavior of adult consumers in the U.S., and will be invaluable in informing a wide range of financial education efforts now and in the future."

"The Council is pleased that Treasury will be consulted on this important project," said Tahira Hira, chair of the President's Advisory Council's Research Committee and a professor at Iowa State University. ""There is so much we still don't know about how Americans handle their money, how they make decisions, how they learn, how they want to learn, what brings about changes in their financial behavior. We hope this study will help answer this and many other questions."

For additional information on Council activities, visit www.treas.gov/financialeducation. Information on the FINRA Foundation may be **found at** www.finrafoundation.org.

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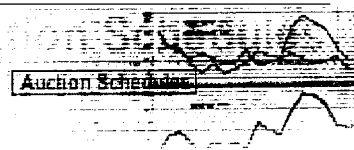

OFFICE OF DOMESTIC FINANCE

Office of Financial Education

Subscribe to Financial Education Updates.

MISSION

The Department of the Treasury is a leader in promoting financial education. Treasury established the Office of Financial Education in May of 2002. The Office works to promote access to the financial education tools that can help all Americans make wiser choices in all areas of personal financial management, with a special emphasis on saving, credit management, home ownership and retirement planning. The Office also coordinates the efforts of the Financial Literacy and Education Commission, a group chaired by the Secretary of Treasury and composed of representatives from 20 federal departments, agencies and commissions, which works to improve financial literacy and education for people throughout the United States.

Financial Literacy and Education Commission - Resources and updates

President's Advisory Council on Financial Literacy - Resources and updates

DID YOU KNOW...

That if all consumers raised their scores by 30 points, total consumer savings would exceed $20 billion?

"Consumer Understanding of Credit Scores Remains Poor," July 2007

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Last Updated: May 1, 2008

ORGANIZATION

Key Personnel

TECHNICAL ASSISTANCE CENTER

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MYMONEY.GOV

The one stop shop for the Federal Government's financial education resources

FLECNATIONALNETWORK.ORG

Comprised of financial literacy materials submitted by state and local governments and associations of these governments

PRESIDENT'S ADVISORY COUNCIL ON FINANCIAL LITERACY INITIATIVES

MoneyMath: Lessons for Life

Community Financial Access Pilot

FINANICAL EDUCATION MATERIALS ON:

Basic Savings

Credit Management

Home Ownership

Retirement Planning

En Español

FIRST ACCOUNTS PROGRAM

July 8, 2008
HP-1070

Remarks by Secretary Henry M. Paulson, Jr. on U.S. Housing Market before FDIC's Forum on Mortgage Lending to Low and Moderate Income Households

Washington, DC--Good afternoon. Thank you Chairman Bair for convening this forum, and thanks to all of you for your interest in encouraging responsible lending to low and moderate income households.

As we all know, this is a timely issue as the housing correction and capital markets turmoil has reduced the availability of credit for mortgages and other lending. Men and women who have worked hard and saved in order to own their own home should know that despite pressures, the mortgage market remains open to them. As the late Ned Gramlich often observed, subprime and other low and middle income lending has played a critical role in helping expand homeownership opportunities for these borrowers. Our responsibility is to work through today's issues and do so in a way that preserves and protects responsible mortgage lending to low and middle income families.

U.S. Housing Market

After several years of lax lending standards and rapid home price appreciation, we are going through an inevitable housing correction. The correction began in 2006, and most forecasters expect a prolonged period of adjustment with foreclosures continuing to rise and housing prices continuing to fall. We are working through the excess new home inventory – the inventory of new single family homes is down 21 percent from its 2006 peak. Another sign that we are well into the adjustment process is that existing home sales appear to have flattened over the past several months, indicating that demand may be stabilizing.

Many of the headlines of falling national home prices are alarming. While prices are undoubtedly declining, the true picture of what homeowners are facing on the ground is varied and cannot be captured in a single national number.

We need to recognize that there is not a national housing market, but a collection of regional markets. Although home prices nationwide experienced rapid price appreciation, price increases were especially pronounced in a few regions. For example, house prices in California, Florida, Arizona and Nevada more than doubled between 2000 and 2006. Similarly, the severity of the current correction varies widely by state and region. These four states, which have 25 percent of all U.S. mortgages, accounted for 42 percent of foreclosure starts in the first quarter of this year, and almost 90 percent of the increase in foreclosure starts. When we add Indiana, Michigan and Ohio, states facing economic challenges, to the aforementioned four states, these seven states comprise 33 percent of mortgages and over 50 percent of foreclosure starts in the first quarter. Foreclosure starts in these states are up 300 percent over the past two years. Of course, that does not mean the correction isn't being felt everywhere; even in the other 43 states, foreclosure starts are up about 90 percent since early 2006. OFHEO's home price data does show, however, that in about one half of the states, home prices actually rose in the first quarter of this year.

In addition, even within a city, home price patterns can be more complex than a single number suggests. We know that foreclosure sales are making up a larger share of total sales than is typical. We also know that foreclosure sales usually occur at a discount to regular home sales. And reported average home sales price is a mix of foreclosure prices and more normal sales prices. Consequently, the prices homeowners realize when selling their home may not be as depressed as the headlines suggest. For example: data from Radar Logic show that in Los Angeles, foreclosure sales in March 2008 were 29 percent of total sales, up from 3

percent in March 2007. In fact, data from this source also show that through March of this year, foreclosure sale prices fell 11 percent in Los Angeles while prices of other homes sold fell 2 percent. This is not intended to minimize what homeowners are experiencing; rather, looking behind the statistics gives us a better understanding of what is really happening.

Beginning last summer, we have implemented a series of public and private initiatives to help struggling homeowners, while also working to minimize the impact of the housing correction, without impeding its necessary progress. The sooner we get through this correction, the sooner we will see home values stabilize, more buyers will return to the housing market and housing will again contribute to economic growth.

In the simplest of terms, the housing market is being negatively impacted by excess inventory and a reduction in the number of homebuyers. These two factors are working in tandem; we cannot reduce the inventory unless we have committed homebuyers. And the availability and price of mortgage financing will affect how many buyers come into the market and when.

There were 1.5 million foreclosures started in all of 2007, and a number of economists now estimate we will see about 2.5 million foreclosures started this year. Even with a strong economy and strong housing market, we saw 800,000 foreclosures started in 2004. Although regrettable, this is normal, and attributable to life events, such as job loss. Public policy cannot be expected to prevent these foreclosures. Many of today's unusually high number of foreclosures are not preventable. Due to the lax credit and underwriting standards of the past years, some people took out mortgages they can't possibly afford and they will lose their homes. There is little public policymakers can, or should, do to compensate for untenable financial decisions. And in the midst of rapid price appreciation, some people bought homes anticipating an immediate profit. Now that their investments have not turned out as they had hoped, these people may walk away, even though they can afford their mortgage payment. These borrowers can and should be living up to their mortgage commitment - government intervention here would be inappropriate. These two categories of foreclosures - stemming from lax underwriting standards and increased speculation - will remain elevated in the near term.

Since last summer, we have been intently focused on avoiding preventable foreclosures: where homeowners, one, want to keep their homes and two, have the financial wherewithal to do so. Here, the challenge we encountered – and it was a big one - was the impending threat of a market failure arising from the complexities and difficulties of a mortgage market that had been transformed by the wide-scale securitization of mortgage financing. Simply put, this impending market failure had the potential to result in many foreclosures that did not make economic sense because it was in the best interest of both the homeowner and the lender to modify the terms of the mortgage so the borrower could stay in the home.

This potential market failure arose from the emergence of the complex originate-to-distribute securitization model where mortgages had been sliced and diced then packaged and sold to investors around the world. The magnitude of the impending correction threatened to overwhelm the normal workout and modification processes in a way that raised a series of technical, legal and accounting issues that likely could not be addressed in a timely fashion by individual market participants working on their own. The result would have been that many borrowers who would otherwise get a modification or refinance would instead go into foreclosure simply because no one could respond to them in time. No responsible homeowner who has been making payments and wants to stay in their home should go into foreclosure merely because the workout system was too busy to find them a solution that is in both the lenders' and the homeowners' best interest.

We sought to address this potential market failure, by working with the industry to facilitate a process that approximates what would be normal behavior between a bank and a struggling borrower if the borrower were dealing with a bank that had originated and held the mortgage. And so last summer, we encouraged the creation of the HOPE NOW Alliance of mortgage lenders, servicers and counselors with the urgent mission of untying the Gordian knot of complexities surrounding the mortgage workout process. In many ways, this has been a race against time. While there have been bumps in the road and there is still work to do, the industry, through HOPE NOW has made an enormous effort and great progress toward

meeting these challenges.

HOPE NOW's numerous efforts to help homeowners avoid preventable foreclosures has been successful. HOPE NOW reports that since last July, the industry has helped 1.7 million homeowners with loan workouts that allowed them to stay in their homes. At the current pace, nearly 200,000 additional borrowers are helped every month. This private sector effort has complemented public efforts to avoid preventable foreclosures, including through expanded access to Federal Housing Administration programs, which has enabled more than 250,000 borrowers to refinance into affordable FHA mortgages since last August.

In particular, there are a number of key areas where HOPE NOW is showing substantial progress. Improved outreach strategies have dramatically increased the response rate of troubled borrowers. Industry is more closely coordinating with mortgage counselors, including paying for counseling. The Alliance members get together routinely, to continuously improve efficiency and reduce the time it takes to respond to a borrower who asks for help. Importantly, modifications as a percent of workouts have climbed from 19 percent to 41 percent for all borrowers. For subprime borrowers, this trend has been even more pronounced, going from 17 to 50 percent. While HOPE NOW is aimed at helping all borrowers, several programs are focused specifically at subprime ARMs. In keeping with recent trends, in the first quarter of 2008 these loans accounted for 6 percent of loans outstanding but 37 percent of foreclosures started – that means that a subprime ARM is four times more likely to have entered foreclosure than a prime ARM and 22 times more likely than a prime fixed-rate mortgage.

In December, HOPE NOW announced a new protocol designed to streamline some subprime ARM borrowers into consideration for a refinancing or modification, so that resources are available for more difficult situations. The objective is not to maximize modifications; it is to minimize foreclosures for those subprime ARM borrowers who could afford the starter rate. From the outset of the HOPE NOW process, I have measured success by whether a borrower who has made all the payments at the initial rate, but couldn't afford the reset and reached out for help avoids going into foreclosure. And so far, the data on this question show an unqualified success.

Of course, lower interest rates have significantly reduced the reset problem. Still, there is no question that because industry has acted to fast-track eligible borrowers, we are achieving our objective. Of the more than 700,000 subprime mortgage resets originally scheduled through May of 2008, only 1800 loans that were current at reset have entered foreclosure. We will continue tracking that number closely to monitor progress. Entire industries do not adjust easily or quickly, even when markets are calm. The HOPE NOW Alliance is demonstrating that an industry can, through coordination, make a difference and do so without forcing American taxpayers to pay the bill.

And we are always pushing to do more. For example, second liens have proven to be an impediment to completing loan workouts as negotiations between borrowers, first lien holders and second lien holders have been complex and time consuming. To help address this, HOPE NOW recently announced guidelines for automatic re-subordination of second liens to enable loan modifications and refinancings to execute more quickly. The American Securitization Forum (ASF) announced today that it would extend its streamlined protocol announced in December to more borrowers than just those experiencing their first rate reset, helping HOPE NOW reach more families. These and other similar efforts will help ensure that the industry as a whole moves together.

Homeowners have responsibility as well. We can't help those who aren't willing to help themselves, and we must continue to urge struggling borrowers that if they haven't already, they need to reach out for help.

Availability of Mortgage Finance

Essential to ending the correction is a return of homebuyers. In many parts of the country a starter home had become unaffordable, and the current correction should bring home prices back within reach for many Americans, so long as financing is available. Those of you here today will have an enormous impact on their ability to get the financing to buy a home.

Two institutions in particular – Fannie Mae and Freddie Mac – have an important role to play. They can be a constructive force in this period of stress in the housing market. I have been strongly encouraging all financial institutions to raise capital so they can continue to finance consumer and business activity that supports our economy. In particular, I am pleased that this spring both GSEs committed to raise more capital. Fannie Mae has raised $7.4 billion in capital in the last several months, and Freddie Mac has committed to raise additional capital. Fannie Mae and Freddie Mac today touch 70 percent of all new mortgages. Fresh capital will strengthen their balance sheets and allow them to provide additional mortgage capital, as they balance their responsibilities to their mission and to their shareholders during this period of housing market adjustment. The availability of mortgage finance is also supported by the Federal Housing Finance Board's decision to allow the Federal Home Loan Banks to increase their purchases of mortgage securities.

Given the very important role being played by the GSEs today, we are particularly focused on completing work to create a world-class regulator for Fannie Mae, Freddie Mac and the Federal Home Loan Banks. A strengthened regulator for Fannie and Freddie will increase investor confidence in these enterprises and will be a substantial tool to ease the housing downturn and increase the availability of affordable mortgages for Americans who want to buy a new home or refinance their current one. Creating a strong independent regulator will help ensure that the GSEs achieve their mission while operating safely and soundly.

The House and Senate have made good progress on GSE reform. As I have continually emphasized, completing this legislation is the single most powerful step Congress can take this year to help our nation get through this housing correction.

That said, working through this correction is made more challenging by the virtual disappearance of the subprime lending market. In response to excesses, that market has probably changed unalterably – as it must. Clearly, some who took out subprime mortgages never should have been approved for a mortgage in the first place. Practices, such as low or no doc loans, minimal or no down payments and other lax credit practices, are likely, as they should be, a thing of the past. At the same time, we cannot lose sight of the fact that subprime lending gave millions of responsible Americans a chance to borrow, despite a less-than-perfect credit history. We must not lose the benefits of the subprime market as we eliminate its flaws. Your discussions today will be instructive as to what products and standards can reinvigorate this important sector of the market, as we know that subprime lending is vital to bring the dream and economic good of homeownership to millions of Americans. The subprime market will evolve as markets always do, to find better ways to evaluate and manage credit risk.

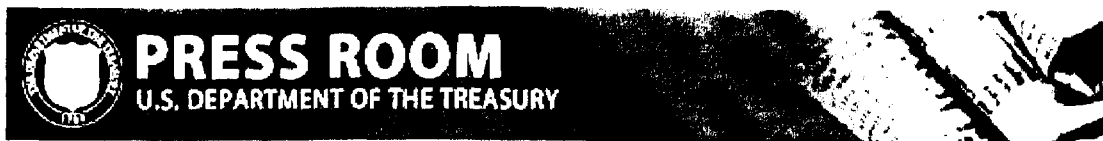
Today we are also looking more broadly for ways to increase the availability and lower the cost of mortgage financing to accelerate the return of normal homebuying activity. We are working with FDIC, the Federal Reserve, the OCC and the OTS to explore the potential of covered bonds, which is one promising financing vehicle to do just that. Covered bonds provide funding to an issuer, generally a depository institution such as a commercial bank or thrift, through a secured debt instrument collateralized by a pool of residential mortgage loans that remain on the issuer's balance sheet. Interest is paid to investors from the issuer's cash flow. In the event of a default, covered bond investors' primary recourse is the pool of mortgage loans, and secondary recourse is an unsecured claim on the issuer. Covered bonds have been widely used in Europe to finance residential and commercial real estate, and municipal bonds. At the end of 2006 the European covered bond market was over 1.9 trillion Euros.

And, as Treasury seeks to encourage new sources of mortgage funding in the United States, improve underwriting standards and strengthen financial institutions' balance sheets, covered bonds have the potential to serve these purposes and reduce the costs for first-time home buyers, and for existing homeowners to refinance.

We are also strengthening efforts to improve financial literacy, so that borrowers better understand sophisticated lending products and the obligations they carry. Through the President's Advisory Council on Financial Literacy, Treasury is identifying approaches to financial education that will help potential borrowers evaluate mortgage options and avoid commitments they cannot meet.

Conclusion

The subprime mortgage turmoil has also revealed broader financial regulatory issues, and we are working to address these on a number of fronts, including modernizing the U.S. financial regulatory structure to better match our modern financial system. Treasury released its recommendations for reform last March, and we look forward to working with all interested parties – the Congress, regulators and market participants – to develop and put in place a better regulatory structure as we work toward an optimal one that hopefully will foster continued progress in mortgage financing while avoiding some of the problems and excesses of the past. Thank you.



July 8, 2008
hp-1071

Treasury Designates Iranian Proliferation Individuals, Entities

Washington - The U.S. Department of the Treasury today designated four individuals and four entities for their ties to Iran's nuclear and missile programs.

"Iran's nuclear and missile firms hide behind an array of agents that transact business on their behalf," said Stuart Levey, Under Secretary for Terrorism and Financial Intelligence. "As long as Iran continues to engage in such deceptive practices, companies and banks must exercise extraordinary vigilance to avoid participating in illicit transactions."

The individuals designated today include Dawood Agha-Jani, Moshen Hojati, Mehrdada Akhlaghi Ketabachi, and Naser Maleki. The entities designated today include Shahid Sattari Industries, Seventh of Tir (a/k/a 7th of Tir), Ammunition and Metallurgy Industries Group (AMIG), and Parchin Chemical Industries.

This action was taken pursuant to Executive Order 13382, an authority aimed at freezing the assets of proliferators of weapons of mass destruction and their supporters, and at isolating them from the U.S. financial and commercial systems. Designations under E.O. 13382 are implemented by the Department of the Treasury's Office of Foreign Assets Control (OFAC) and the State Department, and they generally prohibit transactions between the designees and U.S. persons, and freeze assets the designees may have under U.S. jurisdiction.

The Annex to E.O. 13382, issued by President George W. Bush in June 2005, designated the Atomic Energy Organization of Iran (AEOI), Iran's Aerospace Industries Organization (AIO), the Shahid Bakeri Industrial Group (SBIG), and the Shahid Hemmat Industrial Group (SHIG) as entities of proliferation concern.

The AEOI, which reports directly to the Iranian President, is the main Iranian

organization for research and development activities in the field of nuclear technology, including Iran's centrifuge enrichment program; it also manages Iran's overall nuclear program. The AEOI is identified in the Annex to United Nations Security Council Resolution (UNSCR) 1737 for its involvement in Iran's nuclear program.

Dawood Agha-Jani is being designated because he acts or purports to act for or on behalf of, directly or indirectly, the AEOI. Agha-Jani was listed in UNSCR 1737 for his involvement in Iran's nuclear program, and identified as the head of the Pilot Fuel Enrichment Plant (PFEP) at Natanz. Natanz, which is subordinate to the AEOI, is Iran's main uranium enrichment facility. The PFEP is a test facility that has the capacity to hold 1,000 centrifuges.

Moshen Hojati is being designated because he acts or purports to act for or on behalf of, directly or indirectly, the AIO and the Fajr Industries Group. The AIO, a subsidiary of the Iranian Ministry of Defense and Armed Forces Logistics, is the overall manager and coordinator of Iran's missile program. AIO oversees all of Iran's missile industries. Its subsidiaries, SBIG and SHIG, were both identified in the Annex to UNSCR 1737.

Hojati has been linked to the AIO since at least 2001, serving in various capacities. Hojati was listed in UNSCR 1747 for his involvement in Iran's ballistic missile program, and identified as the head of the Fajr Industries Group, an entity identified in the Annex to UNSCR1737 and designated by OFAC under E.O. 13382, on June 8, 2007, for being owned or controlled by the AIO.

Mehrdada Akhlaghi Ketabachi is being designated because be acts or purports to act for or on behalf of, directly or indirectly, SBIG. As the head of SBIG, Ketabachi plays a key role in SBIG's day-to-day affairs. Ketabachi is also active in negotiating the procurement of equipment for SBIG.

Naser Maleki is being designated because he acts or purports to act for or on behalf of, directly or indirectly, SHIG. Maleki has been identified in UNSCR 1747 as the head of SHIG and an Iranian Ministry of Defense and Armed Forces Logistics (MODAFL) official who oversees work on the Shahab-3 ballistic missile program.

Also designated today is Shahid Sattari Industries, an entity which is owned or controlled by, and acts or purports to act for or on behalf of, directly or indirectly, SBIG. Shahid Sattari Industries is involved in the manufacturing and maintenance of ground support equipment for SBIG.

The other three entities designated today, Seventh of Tir (a/k/a 7th of Tir), Ammunition and Metallurgy Industries Group (AMIG), and Parchin Chemical Industries, are owned or controlled by, or act or purport to act for or on behalf of, directly or indirectly, Iran's Defense Industries Organization (DIO). The U.S. Department of State designated DIO under E.O. 13382 on March 28, 2007, for engaging or attempting to engage in activities or transactions that materially contributed to or pose a risk of materially contributing to the proliferation of weapons of mass destruction or their means of delivery. DIO also is identified in the Annex to UNSCR 1737.

AMIG was listed in UNSCR 1747 for its relationship with Seventh of Tir, which it controls. Seventh of Tir has been involved in a variety of international transactions related to weapons procurement. UNSCR 1737 described Seventh of Tir as a subordinate of DIO, widely recognized as being directly involved in Iran's nuclear program. Seventh of Tir has been connected to Iran's centrifuge development program.

Parchin Chemical Industries is an element of DIO's chemical industries group and is identified in the Annex to UNSCR 1747. As a subordinate of DIO, Parchin acts on behalf of DIO, importing and exporting chemical goods throughout the world. In April 2007, Parchin Chemical Industries was identified as the final recipient of sodium perchlorate monohydrate, a chemical precursor for solid propellant oxidizer, possibly to be used for ballistic missiles.

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REPORTS

- Fact Sheet on Iranian Designations

U.S. DEPARTMENT of STATE

Fact Sheet
Office of the Spokesman
Washington, DC
July 8, 2008

Designation of Iranian Entities and Individuals for Proliferation Activities

The U.S. Government is taking actions today to further U.S. efforts to counter Iran's pursuit of technology that could enable it to develop nuclear weapons and the missiles capable of delivering them. Today, the Departments of State and Treasury designated under Executive Order 13382 six Iranian individuals and five entities of proliferation concern. These actions provide additional information that will help financial institutions in the United States and worldwide protect themselves from deceptive financial practices employed by Iranian entities and individuals engaged in or supporting proliferation.

All UN Member States are required to freeze the assets of entities and individuals listed in the Annexes of UN Security Council resolutions 1737, 1747 and 1803, as well as assets of entities owned or controlled by them, and to prevent funds or economic resources from being made available to them.

Effect of Today's Actions

As a result of our actions today, all transactions involving any of the designees and any U.S. person will be prohibited and any assets the designees may have under U.S. jurisdiction will be frozen. Noting the UN Security Council's grave concern over Iran's nuclear and ballistic missile program activities, the United States also encourages all jurisdictions to take similar actions to ensure full and effective implementation of UN Security Council Resolutions 1737, 1747, and 1803.

Proliferation Finance – Executive Order 13382 Designations

E.O. 13382, signed by the President on June 28, 2005, is an authority aimed at freezing the assets of proliferators of weapons of mass destruction and their supporters, and at isolating them from the U.S. financial and commercial systems. Designations under the Order prohibit all transactions between the designees and any U.S. person, and freeze any assets the designees may have under U.S. jurisdiction.

Iranian Individuals

Mohsen Fakhrizadeh-Mahabadi: Fakhrizadeh was named in that annex of UNSCR 1747; he is a senior scientist at the Ministry of Defense and Armed Forces Logistics (MODAFL) and former head of the Physics Research Centre (PHRC). The International Atomic Energy Agency (IAEA) has asked to interview him about the activities of the PHRC over the period he was head of the PHRC, but Iran has refused.

Yahya Rahim Safavi: Safavi was named in the annex of UNSCR 1737 as the Commander of the Iranian Revolutionary Guard Corps (IRGC) and the UNSC listed him as the involved in both Iran's nuclear and ballistic missile programs. On September 1, 2007, Safavi was replaced as IRGC Commander and appointed as advisor and senior aide for armed forces affairs to the Supreme Leader of the Islamic Republic of Iran Ayatollah Seyyed Ali Khamenei.

Dawood Agha-Jani: Agha-Jani was named in the annex of UNSCR 1737 for his involvement in Iran's nuclear program, and identified as the head of the Pilot Fuel Enrichment Plant (PFEP) at Natanz. Natanz, which is subordinate to the Atomic Energy Organization of Iran (AEOI), is Iran's main uranium enrichment facility. The PFEP is a test facility that has the capacity to hold ,000 centrifuges.

Mohsen Hojati: Hojati was named in the annex of UNSCR 1747 for his involvement in Iran's ballistic missile program. Hojati has been linked to the Aerospace Industries Organization (AIO) since at least 2001, serving in various capacities. He has also been identified as the head of the Fajr Industries Group, an entity designated by OFAC under E.O. 13382 on June 8, 2007, for being owned or controlled by the AIO.

Mehrdada Akhlaghi Ketabachi: Ketabachi was named in the annex of UNSCR 1747. As the head of the Shahid Bakeri Industrial Group (SBIG), Ketabachi plays a key role in SBIG's day-to-day affairs. Ketabachi is also active in negotiating the procurement of equipment for SBIG.

Naser Maleki: Maleki was named in the annex of UNSCR 1747 as the head of the Shahid Hemmat Industrial Group (SHIG) and an Iranian Ministry of Defense and Armed Forces Logistics (MODAFL) official who oversees work on the Shahab-3 ballistic missile program. As head of SHIG, Maleki is involved in multiple aspects of SHIG operations.

Iranian Companies

The TAMAS Company: TAMAS was named in the annex of UNSCR 1803 for its involvement in enrichment-related activities. The UNSC listed TAMAS as the overarching body, under which four subsidiaries have been established, including one for uranium extraction to concentration and another in charge of uranium processing, enrichment and waste.

Shahid Sattari Industries: Shahid Sattari Industries is involved in the manufacture and maintenance of ground support equipment for SBIG.

The other three entities designated today, Seventh of Tir (a/k/a 7th of Tir), Ammunition and Metallurgy Industries Group (AMIG), and Parchin Chemical Industries, are owned or controlled by, or act or purport to act for or on behalf of, directly or indirectly, Iran's Defense Industries Organization (DIO). The U.S. Department of State designated DIO under E.O. 13382 on March 30, 2007, for engaging in activities that materially contributed to the development of Iran's nuclear and missile programs.

7th of Tir: Seventh of Tir was named in the annex of UNSCR 1737, which described Seventh of Tir as a subordinate of Defense Industries Organization (DIO), widely recognized as being directly involved in Iran's nuclear program. Seventh of Tir has been involved in a variety of international transactions related to weapons procurement. Seventh of Tir has been connected to Iran's centrifuge development program.

Ammunition and Metallurgy Industries Group (AMIG): AMIG was named in the annex of UNSCR 1747 for its relationship with Seventh of Tir, which it controls. AMIG was also designated for its relationship with DIO.

Parchin Chemical Industries: Parchin was listed in the annex of UNSCR 1747. As a subordinate of DIO, Parchin acts on behalf of DIO and is an element of DIO's chemical industries group, importing and exporting chemical goods throughout the world. In April 2007, Parchin Chemical Industries was identified as the final recipient of sodium perchlorate monohydrate, a chemical precursor for solid propellant oxidizer, possibly to be used for ballistic missiles.

Iran Designation Identifier Information Pursuant to E.O. 13382
July 8, 2008

1. Individual: **Mohsen Fakhrizadeh mahabadi**

AKA: Mohsen Fakhrizadeh
AKA: Fakhrizadeh
Passport Numbers: A0009228, 4229533

2. Individual: **Yahya Rahim Safavi**

AKA: Rahim Safavi
AKA: Yahya Rahim-Safavi
AKA: Sayed Yahya Safavi
AKA: Yahia Rahim Safawi
AKA: Seyyed Yahya Rahim-Safavi
AKA: Yahya Rahim Al-Sifawi
Date of Birth: March to September 1952-1953
Place of Birth: Esfahan, Iran

3. Individual: **DAWOOD AGHA-JANI**

AKA: Davood Aghajani
AKA: Davoud Aghajani

AKA: Davud Aghajani
AKA: Kalkhoran Davood Aghjani
AKA: Da'ud Aqajani Khamena
Date of Birth: April 23, 1957
Place of Birth: Ardebil, Iran
Passport Number: I5824769 (Iran)
Nationality: Iran

4. Individual: **MOHSEN HOJATI**

Address: c/o Fajr Industries Group, Tehran, Iran
Date of Birth: September 28, 1955
Place of Birth: Najafabad, Iran
Passport Number: G4506013 (Iran)
Nationality: Iran

5. Individual: **MEHRDADA AKHLAGHI KETABACHI**

Address: c/o Shahid Bakeri Industrial Group, Tehran, Iran
Date of Birth: 10 September 1958
Passport Number: A00030940-04

6. Individual: **NASER MALEKI**

AKA: Nasser Maleki
Address: c/o Shahid Hemmat Industrial Group, Tehran, Iran
Date of Birth: circa 1960
Passport Number: A0003039

7. Entity: **The TAMAS Company**

AKA: TAMAS
AKA: Nuclear Fuel Production Company
Location: No.84, 20th street. Northern Kargar Avenue. Tehran, 10000. Iran.

8. Entity: **SHAHID SATTARI INDUSTRIES**

AKA: Shahid Sattari Group Equipment Industries
Location: Southeast Tehran, Iran

9. Entity: **7TH OF TIR**

AKA: 7th of Tir Complex
AKA: 7th of Tir Industrial Complex
AKA: 7th of Tir Industries
AKA: 7th of Tir Industries of Isfahan/Esfahan
AKA: Mojtamae Sanate Haftome Tir
AKA: Sanaye Haftome Tir
AKA: Seventh of Tir
Location: Mobarakeh Road Km 45, Isfahan, Iran
Alternate Location: P.O. Box 81465-478, Isfahan, Iran

10. Entity: **AMMUNITION AND METALLURGY INDUSTRIES GROUP**

AKA: AMIG
AKA: Ammunition and Mettalurgy Industry Group
AKA: Ammunition Industries Group
AKA: Sanaye Mohematsazi
Location: P.O. Box 16765-1835, Pasdaran Street, Tehran, Iran

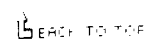
Alternate Location: Department 145-42, P.O. Box 16765-128, Moghan Avenue, Pasdaran Street, Tehran, Iran

11. Entity: **PARCHIN CHEMICAL INDUSTRIES**

AKA: Para Chemical Industries
AKA: Parchin Chemical Factories
AKA: Parchin Chemical Industries Group
AKA: PCF
AKA: PCI
Location: 2nd Floor Sanam Bldg., 3rd Floor Sanam Bldg., P.O. Box 16765-358, Nobonyad Square, Tehran, Iran
Alternate Location: Khavaran Road Km 35, Tehran, Iran

2008/556

Released on July 8, 2008



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July 9, 2008
HP-1072

Under Secretary David H. McCormick
Remarks on Treasury's Changing Role in a Global Economy
at the Center for International & Strategic Studies

Washington - Today's global economic and financial system is characterized by increasingly interconnected financial markets and expanding cross-border capital flows. While bringing enormous benefits and efficiencies to the U.S. and global economies, this also makes our economy more vulnerable to risks or disruptions that exist or could arise in far off places around the globe. In today's environment, we are also uniquely challenged with protecting our national security by countering new threats from illicit finance and rebuilding fragile security environments which are of paramount concern.

Moreover, global public goods such as addressing climate change or rises in commodity prices have taken on important economic implications and growing urgency. Simply put, the challenges we presently face are more complex, more diverse, and more interdependent than those of the past. Not surprisingly, to be effective in this rapidly changing environment, the Treasury Department has had to make some dramatic changes in how we define our mission and how we are organized to achieve it. We have also had to develop new capabilities at home and abroad to address these challenges. Treasury's core mission has typically involved supporting the integrity and strength of financial markets and promoting U.S. and global economic growth and stability. In recent months, the traditional role of responding to crises and supporting global financial stability has been underscored by the rapid and comprehensive policy response that has been required during the current financial market turmoil.

But Treasury has also developed and deployed new capabilities in other critical areas to: (1) combat illicit finance, (2) ensure economic renewal and stability in post-conflict countries, (3) fight rising protectionism, and (4) support, and where appropriate, lead multilateral efforts to protect the environment in tandem with sustainable economic growth.

Today's Treasury is very different from the one that existed seven and a half years ago, or even two years ago when Secretary Paulson joined the Administration. While there is certainly much more to be done, we are well prepared to develop and execute U.S. economic policy in these dynamic times.

Financial Market Turmoil

At the center of Treasury's current efforts is maintaining the health and stability of the U.S. economy. The U.S. economy is facing significant headwinds – sharp reductions in the housing sector, turmoil in the capital markets, and rapidly rising energy prices. Though these challenges are serious, and we expect to be working through them for some time, the long-term prospects for the U.S. economy – and the underlying fundamentals on which it is based – remain sound. Policymakers in the United States and around the world are taking aggressive and targeted actions to stabilize financial markets, reduce the impact of markets on the U.S. economy, and protect against the same mistakes being repeated.

Our highest priority has been to address the challenges arising from market turmoil and the housing downturn, so as to reduce the impact on the rest of the economy. The Administration and Congress responded with a $150 billion bipartisan stimulus package when it became clear that the market turmoil posed significant risks to the U.S. economy. Policymakers also launched a series of housing-market initiatives to help millions of Americans by preventing avoidable foreclosures.

Enhanced domestic regulatory coordination has been a key part of the response. In

the United States, the President's Working Group on Financial Markets (PWG), chaired by Secretary Paulson, reviewed the causes of the recent turmoil and made recommendations to mitigate systemic risk, restore investor confidence, and facilitate stable economic growth. These recommendations are presently being implemented.

International regulatory coordination has also been a priority. Today's global markets require an international response to guard against uneven national responses and the risks of regulatory arbitrage. Therefore, we have worked closely with counterparts in major economies around the world to address the market instability consistently and comprehensively. The Financial Stability Forum (FSF), which brings together the supervisors, central banks, and finance ministries of major financial centers, has been critical to this effort. The FSF has released a number of recommendations that echo and complement efforts underway in the United States.

Beyond the near-term actions, there is also a need to ensure that all financial systems periodically reassess their effectiveness. Thus, well before the market turmoil began last summer, the Treasury began to consider how to modernize our outdated financial regulatory structure. The recently released *Blueprint for a Modernized Financial Regulatory Structure* proposes an objectives-based approach consisting of three regulators: a market stability regulator, a prudential regulator for institutions with federal guarantees, and a business conduct regulator with a focus on consumer protection.

We see this combination of initiatives already beginning to have a positive effect. As with other periods of market instability, this storm too shall pass. The United States will work through these challenges and emerge as it has in the past as a driver of growth and innovation for the global economy.

These efforts, while critical, should be no surprise. It is at the center of Treasury's long-standing mandate to ensure global financial stability. What some of you may not know about, however, are the other critical efforts underway over the past year that are reflective of Treasury's changing role in a globalized world.

Combating Illicit Finance

A relatively new, but important area of Treasury involvement in national security is in combating illicit financial activity. To manage the threat to the international financial system, Treasury has built up its capabilities to target state sponsors of terror and prevent the proliferation of weapons of mass destruction (WMD). We have also coupled these domestic actions with coordinated multilateral efforts and actual engagement with the international financial community to increase the effectiveness of our work.

Within Treasury, the Administration created a new office--the Office of Terrorism and Financial Intelligence (TFI)--led by an Under Secretary and dedicated to targeting the financial networks supporting illicit actors, including narcotics traffickers and terrorist groups. This office was the beginning of a transformation within Treasury to play a more strategic role in combating terrorism. We have also created an in-house intelligence analysis office to bring the knowledge of the intelligence community to bear on the threat of illicit finance.

Iran is a case in point. We have seen that a combination of targeted financial measures can put real pressure on the regime and its continued pursuit of a nuclear capability and support for terrorist groups. Diplomatic efforts have resulted in three UN Security Council Resolutions targeting the entities and individuals that support Iran's attempts to develop WMDs. Treasury is working to implement these resolutions and prevent illicit conduct through targeted financial measures against Iranian banks, entities, and individuals engaged in these activities.

Treasury is also coordinating international efforts to alert the financial community to the threats of money laundering and terrorist financing. In February 2008, the world's premier standard-setting body on countering the financing of terrorism and the laundering of money -- the Financial Action Task Force (FATF) -- called on all governments to issue advisories to their financial institutions, warning them of the risks of dealing with Iran. All 32 member countries and jurisdictions have responded by issuing warnings about Iran, and on June 23 the European Union moved to

designate and freeze the assets of Iran's largest state owned bank, Bank Melli.

The bottom line is that these efforts are making a difference. Earlier this year, Ali Larijani, who served as Iran's top nuclear negotiator, said, "These sanctions are a burden on the economy. Rising inflation, an unemployment rate that is not falling, and the high cost of living are all direct consequences of the sanctions." We have learned that sanctions, especially targeted ones, will always be more effective when done on a multilateral basis.

Post-Conflict Rebuilding

Another facet of Treasury's greater role in national security can be seen in our work supporting the development of economies in difficult security environments. Through our experiences in war-torn countries in the Balkans, the Middle East, and Africa, the United States has learned that security and economic stability must go hand in hand if we are to achieve lasting peace. Treasury's role is to devise and implement strategies that avert financial crises and to promote policies that generate sustainable growth and job creation. To do this right, we have to put people in the field – both financial attachés and technical advisors. In fact, we had some of the first civilians on the ground in Afghanistan and Iraq – as well as in places like Kosovo, Bosnia, and Liberia.

These critical personnel assess the situation on the ground and help us respond with appropriate measures. Treasury has played a major role, for example, in helping the Government of Iraq create a more stable macroeconomic environment and build a solid foundation for economic growth. Following the fall of Saddam Hussein, our advisors alerted us that rampant counterfeiting could lead to a collapse in the value of currency, feeding inflation and civil unrest. Under the leadership of one of my predecessors, John Taylor, they then developed a comprehensive strategy for creating, printing and circulating a new currency to 250 distribution points around the country.

Currently, we are working with the military to help Iraq use its resources more effectively to ensure that essential services--like electricity--get to the people. Because these efforts are so important to preserving recent security gains, we are planning to more than double our existing presence in Iraq. This plan is closely coordinated with the military command, which will provide logistical and security support for new advisors. General Petraeus has told me personally that he views the deployment of these twelve additional Treasury advisors as a top priority.

We have also made similar contributions in Afghanistan, where our advisors helped the Afghan Ministry of Finance craft the first post-Taliban budget working with nothing more than an Excel spreadsheet. And our debt management experts have helped Afghanistan secure over $10 billion in international debt relief and build capacity to avoid falling back into unsustainable debt. Without progress in these areas, Afghanistan has little hope of achieving a lasting and economically viable peace. We know that by helping these countries govern effectively and achieve economic success, their citizens will develop a stake in political stability, eliminating the longer term need for boots on the ground.

Investment Policy

A fourth area posing new challenges and new responsibilities for the Treasury is the growing risk of protectionism, particularly directed toward foreign investment, including investment from sovereign wealth funds, here in the United States. In the aftermath of 9/11, we have seen a backlash against foreign investment on national security grounds, with some voicing concerns about the potential for foreigners to gain control over key sectors or critical technologies within our borders.

Foreign control over U.S. businesses may, in some cases, raise genuine national security concerns. But we also know that foreign direct investment flows into the United States strengthen the U.S. economy by stimulating growth and creating jobs. U.S. affiliates of foreign multinationals employ over five million U.S. workers, or 4.5 percent of all private sector employment. Foreign-owned firms in the United States also pay on average 25 percent more than U.S. firms and help stimulate investment in research and development in high-technology areas that promote innovation and competitiveness. Thus, a significant component of our economic policy mission is safeguarding national security but in a manner that maintains and strengthens the

U.S. economy through our longstanding commitment to an open investment policy.

Recent proposals in other countries for additional restraints on foreign investment raise some concerns in this regard. Investment reviews must be strictly limited to genuine national security concerns, not broader economic or national interests. In the United States, the interagency Committee on Foreign Investment (CFIUS), chaired by Secretary Paulson, reviews certain foreign investments in U.S. businesses to determine whether they raise any genuine national security concerns. The preponderance of transactions in the United States do not require a CFIUS review, and for cases that do, we are taking steps to clarify and streamline the process.

Foreign government-controlled investment, particularly from sovereign wealth funds (SWFs), has also garnered a great deal of attention recently. The rapid growth in number and size of SWFs does raise legitimate financial stability and investment policy questions that should be addressed through a measured, multilateral approach that maintains openness. Treasury has taken a number of steps to help accomplish this objective, including proposing and strongly supporting the IMF effort to develop voluntary best practices for SWFs and urging the OECD to identify inward investment policy best practices for countries that receive sovereign wealth investments. Both initiatives are well underway. The IMF expects to complete best practices by October 2008 -- covering areas such as fund objectives, institutional and governance arrangements, risk management and transparency. The OECD will issue investment policy principles later this year.

Energy and the Environment

Finally, Treasury's work has ventured into energy and environmental policy, an area largely ignored by finance ministries up until now. This is a part of Treasury's portfolio where our interactions with the emerging economies are particularly important. Since 2002, developing countries have been responsible for about two-thirds of global GDP growth, and not surprisingly, the environmental implications of their exploding energy needs are daunting.

While this unprecedented expansion has brought economic opportunities and higher standards of living to these previously impoverished countries, it has also led to surging demand for energy in the power, transport, building, and industrial sectors. The International Energy Agency (IEA) estimates that last year China surpassed the U.S. as the largest global greenhouse gas emitter and the rate of emissions growth of developing countries will soon surpass those of developed countries. The need for sustainable economic growth, in a way that protects our planet, is one of the most pressing challenges facing our country.

Recognizing this fact, President Bush asked Secretary Paulson in September 2007 to take the lead in establishing a major multilateral initiative to create a new international clean technology fund to help developing countries harness the power of clean energy technologies to place themselves on a cleaner emissions growth trajectory. The Clean Technology Fund (CTF), which is to be housed at the World Bank, aims to reduce the growth of greenhouse gas emissions in developing countries by helping to finance the additional costs of deploying clean energy technologies over cheaper, dirtier alternatives. It will stimulate and leverage private sector investment in existing clean technologies, and it will promote international trust and cooperation on climate change, a prerequisite for a future climate change agreement.

Secretary Paulson has led U.S. efforts to build support for the development of this fund, in conjunction with the UK and Japan, the other founding partners. Earlier this month, the G-8 Finance Ministers issued a strong statement endorsing the Fund and calling on other countries to participate, and this week, G-8 countries collectively pledged over $5 billion for CTF. This Fund is one important step that the United States can take along with the other developed countries to demonstrate leadership and to contribute constructively to broader international efforts to mitigate the effects of climate change.

Clearly, climate change will have lasting economic effects as will the policies that are developed to address it. Treasury must play a critical role in policy development and implementation. As a result, we have created a new senior position, and a dedicated team, specifically for providing leadership on both international and domestic economic policy issues related to the environment.

A Broader Reform Agenda

Today I have focused on the U.S. Treasury's changing role in the global economy and ways that we have adapted to meet these new challenges. But we are not alone in needing to reform. There is also a pressing need to evolve among finance ministries, central banks, regulators, the International Monetary Fund (IMF), and the Multilateral Development Banks (MDBs) around the world. There are a few areas in particular deserving a brief mention.

First, coordination and cooperation on international economic policy can no longer be isolated to the G-7 countries alone. As dynamic emerging economies increase their share of and integration into the global economy, our existing dialogues such as the G-7 and G-8, the G-20, the Financial Stability Forum, and others must adapt to accommodate the increasingly important role played by these countries.

Likewise, the international financial institutions, such as the International Monetary Fund, must also reform in order to remain relevant. The IMF has taken an important first step to reform its governance structure to reflect the growing weight of dynamic emerging markets by reforming the quota and voice representation of its members. It needs to further evolve by strengthening its multilateral and bilateral surveillance capabilities, focusing on exercising firm exchange rate surveillance, encouraging openness to international investment, and supporting global financial market stability.

For the MDBs, this means considering how to effectively address their core missions to promote economic development and reduce poverty. They should also consider how to work more effectively within their comparative advantages vis-à-vis other donors and how to leverage their unique convening ability to help tackle global public goods such as climate change, HIV/AIDS, and escalating food prices in a coordinated way. We see, as an example, the World Bank under Bob Zoellick's leadership making important strides in this direction.

As the world has transformed around us, Treasury has had to rethink its role in the global economy and the ways we fulfill our mission. Even as many of our longer-term goals and priorities – such as ensuring stable growth and maintaining global financial stability – have not changed, the way we do business to achieve them has. The challenges I discussed today are just a few examples of the many we face.

In these rapidly changing times, economic policymakers around the world must continuously review and adapt how they are defining and conducting their missions. While our journey is far from complete, the U.S. Treasury Department has made important progress on this front.

Thank you for your attention.

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July 9, 2008
HP-1073

Statement by Treasury Secretary Henry M. Paulson, Jr.
On Staff Changes in The Office of Domestic Finance

Washington- Treasury Secretary Henry M. Paulson, Jr. made the following statement today regarding the resignation of Under Secretary for Domestic Finance Robert K. Steel and the broader role that Assistant Secretary for Financial Markets Anthony W. Ryan will take on in the Department.

"Bob Steel has been a friend and colleague to me for more than 30 years. He has served the President and the public with ingenuity and dedication during extraordinary times in our financial markets. I know he will excel in his future endeavors," said Secretary Paulson.

Assistant Secretary for Financial Markets Anthony W. Ryan will take on a broader role managing Treasury's domestic finance and financial markets agenda. Assistant Secretary for Financial Institutions David Nason will continue to spearhead regulatory reform efforts and oversee financial institutions policy, including issues surrounding the government sponsored enterprises. Steven Shafran, who had 22 years of experience in finance before coming to Treasury, will take on a broader role in his current capacity as Senior Adviser to the Secretary. Assistant Secretary Kenneth Carfine will continue to oversee the government's fiscal operations, including managing federal financing needs and the government's cash flow. Deputy Assistant Secretary for Financial Institutions Policy Jeremiah Norton will take on additional financial institutions responsibilities.

"I have great confidence in the abilities of the Domestic Finance team at Treasury to adjust to this change and not miss a beat," said Secretary Paulson.

Under Secretary Steel was sworn in on October 10, 2006. Assistant Secretary Ryan joined the Treasury first as Senior Adviser to the Secretary in July 2006 and was sworn into his current position on December 18, 2006. Assistant Secretary Nason was first sworn in as Deputy Assistant Secretary for Financial Institutions Policy in October 2005; he was promoted to Assistant Secretary and sworn in on June 28, 2007. Assistant Secretary Carfine was sworn in on March 15, 2007 and has served the federal government for 35 years. Deputy Assistant Secretary Norton was named to his position on June 12, 2007. Steven Shafran joined the Treasury Department in February 2008 as a Senior Adviser to the Secretary.

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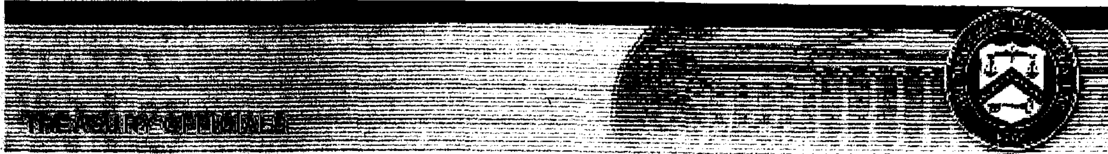
REPORTS

- Steel Resignation Letter (PDF)



Robert Steel
Under Secretary for Domestic Finance

On Tuesday, October 10, 2006, Robert K. Steel was sworn in as the Under Secretary of the Treasury for Domestic Finance. In that capacity, he serves as the principal adviser to the Secretary on matters of domestic finance and leads the Department's activities with respect to the domestic financial system, fiscal policy and operations, governmental assets and liabilities, and related economic and financial matters.

Robert K. Steel retired from Goldman Sachs as a vice chairman of the firm on February 1, 2004. He joined Goldman Sachs in 1976 and served in the Chicago office until his transfer to London in 1986. In London he founded the Equity Capital Markets group for Europe and was extensively involved in privatization and capital raising efforts for European corporations and governments. He later assumed the position as head of Equities for Europe. In 1994 he relocated to New York and served as head of the Equities Division from 1998-2001 until his appointment as a vice chairman of the firm. He became a partner in 1988 and joined the Management Committee in 1999. Upon his retirement from Goldman Sachs, he assumed the position of advisory director for the firm and then senior director in December 2004.

From February 2004 to September 2006 Mr. Steel served as a senior fellow at the Center for Business and Government at the John F. Kennedy School of Government at Harvard University.

Mr. Steel received his undergraduate degree from Duke University and his MBA from the University of Chicago. He resides in Connecticut and Washington, D.C. with his wife and three daughters.

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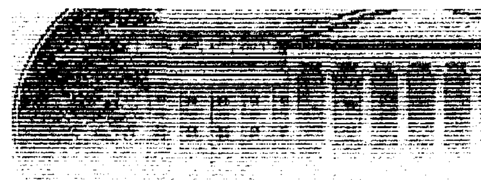

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Treasury Officials

Anthony Ryan
Assistant Secretary for Financial Markets

Open Print Version | Hi-Resolution Photo

Anthony W. Ryan was sworn in as Assistant Secretary of the Treasury for Financial Markets on December 18, 2006.

As the Assistant Secretary for Financial Markets, Anthony Ryan serves as senior adviser to the Secretary, Deputy Secretary, and Under Secretary on broad matters of domestic finance, financial markets, Federal, State and local finance including the Federal debt, Federal Government credit policies, lending and privatization. He oversees issues involving Treasury financing, public debt management, Federal regulation of financial markets and related economic matters including regulatory issues in the Government securities markets and the futures markets.

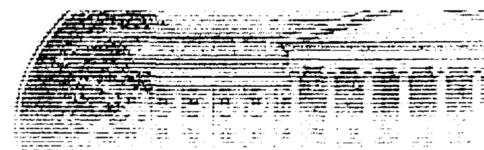
Mr. Ryan also serves as the senior member of the Treasury Financing Group and coordinates the inter-agency President's Working Group on Financial Markets. In addition, he oversees the Office of Debt Management and the Office of Government Financial Policy, as well as the operations of a set of commissions and board staff.

Prior to his confirmation as Assistant Secretary, Mr. Ryan served as a Senior Advisor to U.S. Treasury Secretary Henry M. Paulson. In that capacity he provided counsel to the Secretary and the Treasury Chief of Staff on key policy matters. Mr. Ryan also coordinated issues within the Department and its bureaus, as well as with the White House and other agencies.

Before joining the Treasury Department, Mr. Ryan spent 20 years in the financial services industry. Most recently, he was a partner of Grantham, Mayo, van Otterloo & Co. LLC (GMO). Prior to GMO, Mr. Ryan was a portfolio manager and business executive for global institutional asset management firms including State Street Corporation and The Boston Company.

Mr. Ryan graduated from the University of Rochester in 1985, and received his Masters Degree from the London School of Economics & Political Science in 1986. He and his wife, Ann, and four children live in Washington, D.C.

Last Updated: December 20, 2006



Treasury Officials

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David G. Nason
Assistant Secretary for Financial Institutions

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In 2007, David G. Nason was confirmed as Assistant Secretary for Financial Institutions. In this role he serves as a senior advisor to the Secretary, the Deputy Secretary and the Under Secretary for Domestic Finance on all matters relating to financial institutions, government sponsored enterprises, financial education initiatives, the CDFI Fund and ensuring the resilience of the financial services sector.

Previously, Mr. Nason served as Deputy Assistant Secretary for Financial Institutions. In this position, Mr. Nason oversaw the Office of Financial Institutions Policy which develops, analyzes, and coordinates the Department's policies on legislative and regulatory issues affecting financial institutions.

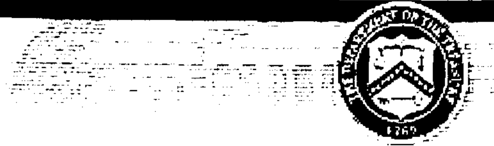
Mr. Nason also serves as a key adviser to the Treasury Secretary in his capacity as Chair of the President's Working Group on Financial Markets. The President's Working Group also consists of the Chairs of the Federal Reserve Board, the Securities and Exchange Commission, and the Commodity Futures Trading Commission. Nason oversees the Terrorism Risk Insurance Program, which is the Treasury office that implements and manages the program created by the Terrorism Risk Insurance Act of 2002.

Prior to Treasury, Mr. Nason was at the Securities & Exchange Commission where he served as counsel to Commissioner Paul S. Atkins. In this capacity, he served as a primary adviser for capital raising and corporate governance issues, Gramm-Leach-Bliley compliance, and hedge fund and mutual fund initiatives.

Prior to joining the SEC, Mr. Nason was an attorney at Covington & Burling in Washington, D.C., where he focused on securities offerings, mergers and acquisitions, and federal tax planning. Nason previously served as law clerk to the Honorable Marvin J. Garbis of the U.S. District Court for District of Maryland.

A native of Providence, Rhode Island, Mr. Nason received a B.S. in Finance from The American University, and a J.D., summa cum laude, from The Washington College of Law at The American University. He is married and has two daughters and a son.

Last Updated: March 21, 2008



TREASURY OFFICIALS

Kenneth E. Carfine
Fiscal Assistant Secretary

Ken Carfine was appointed Fiscal Assistant Secretary, a career position, on March 15, 2007.

In this position, Mr. Carfine provides policy oversight over the two Fiscal Service Bureaus -- the Financial Management Service and the Bureau of the Public Debt. This office also serves as the Treasury's liaison with the Federal Reserve System in its role as the government's fiscal agent. The scope of his responsibilities includes managing the government's cash flow, improving government financial management, executing the government's financing activities and overseeing the operation of government-wide financial accounting and reporting systems, including the preparation of the Consolidated Financial Statements of the United States. In addition, Mr. Carfine is a statutory member of the Government-wide CFO Council, and represents the Secretary on the Trust Fund Boards for the National Archives and Library of Congress.

Previously, Mr. Carfine was the Deputy Assistant Secretary for Fiscal Operations and Policy, a position to which he was appointed in April 2003. In that position, he advised and assisted the Fiscal Assistant Secretary on a broad range of policy and operational matters related to the fiscal activities of the Treasury, and oversaw the development and implementation of policies relating to the government's cash and investment management, debt financing, trust fund investment and administration, payments, collections and debt collection. He also worked closely with the Financial Management Service, the Bureau of the Public Debt, and the Federal Reserve System in the execution of his duties.

Mr. Carfine began his Treasury career in 1973 with the Financial Management Service, holding positions of increasing responsibility in areas of banking, cash management, payments, check claims, and government-wide accounting.

Mr. Carfine graduated from the University of Baltimore with a B.S. degree in Accounting. He and his wife, Deborah, have two sons and one granddaughter and live in Maryland.

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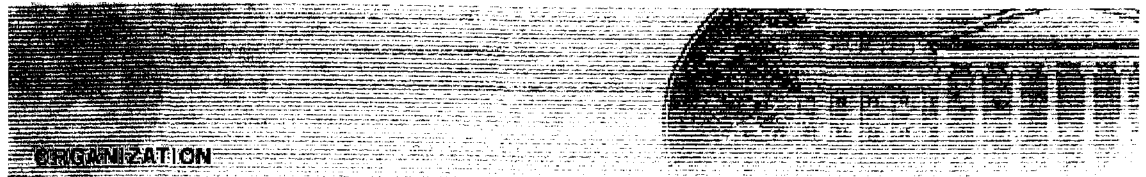

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Jeremiah Norton
Deputy Assistant Secretary for Financial Institutions Policy

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Jeremiah O. Norton was named Deputy Assistant Secretary for Financial Institutions on June 12, 2007. In this position, Norton oversees the Office of Financial Institutions Policy which develops, analyzes, and coordinates the Department's policies on legislative and regulatory issues affecting financial institutions, including depository institutions, insurance companies, government sponsored enterprises, securities firms, finance companies, mutual funds, and all other regulated and unregulated financial intermediaries. The Office's principal focus is on issues dealing with safety and soundness, market structure, condition, and competitiveness, and regulatory structure. Norton also oversees the Terrorism Risk Insurance Program, which is the Treasury office that implements and manages the program created by the Terrorism Risk Insurance Act of 2002.

Prior to Treasury, Norton served on the legislative staff of Representative Edward R. Royce, a senior Member of the House Committee on Financial Services. In this capacity, he served as the primary adviser on issues such as banking, insurance, securities, and government sponsored enterprises. Prior to joining Representative Royce, Norton worked in the Financial Institutions and Governments investment banking group at J.P. Morgan Securities, Inc.

A native of McLean, Virginia, Norton received an A.B. in Economics from Duke University, and a J.D. from the Georgetown University Law Center.

July 10, 2008
HP-1074

**Oral Statement by Secretary Henry M. Paulson, Jr.
on Regulatory Reform before House Committee on Financial Services**

Washington, DC-- Mr. Chairman, Ranking Member Bachus, thank you for holding this hearing, and for your leadership on these important issues. As you know, our financial markets have been experiencing turmoil since last August. It will take additional time to work through challenges. Progress has not come in a straight line but much has been accomplished. Our financial institutions are repricing risk, deleveraging, recognizing losses, raising capital and improving their financial position. Their ability to raise capital even during times of stress is a testament to our financial institutions and our financial system.

Fannie Mae and Freddie Mac are also working through this challenging period. They play an important role in our housing markets today and need to continue to play an important role in the future. Their regulator has made clear that they are adequately capitalized.

Market practices and discipline on the part of financial institutions and investors are also improving. Our regulators are shining a light on our challenges. Through the PWG, we have issued a report analyzing the causes of the turmoil and recommending a comprehensive policy response, implementation of which is well underway. Regulators are enhancing guidance, issuing new rules, and communicating more effectively across agencies – domestically and internationally.

Although our regulatory architecture and authorities are outdated and less than optimal, we have been working together, while respecting our different authorities and responsibilities, to ensure the stability of the financial system, because it is in the interest of the American people that we do so. Today this is by far our most important priority. And our seamless cooperation to achieve it is made possible by the leadership and support provided by this committee and other leaders in Congress.

I have confidence in our regulators and markets. We need to remain focused and continue to address challenges with your help and support, but we will ultimately emerge with strong capital markets, which in turn will enable our economy to continue to grow.

Looking beyond this period of market stress, which will eventually pass as these situations always do, I have presented my ideas for improving our regulatory structure and expanding our emergency powers. And I look forward to discussing these ideas with you today, even as we continue our primary focus on confronting current challenges and maintaining stable, orderly financial markets.

In March, I laid out a Blueprint for a Modernized Financial Regulatory Structure, in which we recommended a U.S. regulatory model based on objectives that more closely link the regulatory structure to the reasons why we regulate. Our model proposes three primary regulators: one focused on market stability across the entire financial sector, another focused on safety and soundness of institutions supported by a federal guarantee, and a third focused on protecting consumers and investors.

A major advantage of this structure is its timelessness and its flexibility and that, because it is organized by regulatory objective rather than by financial institution category, it can more easily respond and adapt to the ever-changing marketplace. If implemented, these recommendations eliminate regulatory competition that creates inefficiencies and can engender a race to the bottom.

The Blueprint also recommends a number of near-term steps. These include

formalizing the current informal coordination among U.S. financial regulators by amending and enhancing the Executive Order which created the President's Working Group on Financial Markets and, while retaining state-level regulation of mortgage origination practices, creating a new federal-level commission, the Mortgage Origination Commission to establish minimum standards for, among other things, personal conduct and disciplinary history, minimum educational requirements, testing criteria and procedures, and appropriate licensing revocation standards.

The Blueprint includes recommendations on a number of intermediate steps as well – focusing on payment and settlement systems and on areas, such as futures and securities, where our regulatory structure severely inhibits our competitiveness. We recommend the creation of an Optional Federal Charter for insurance companies, similar to the current dual-chartering system for banking, and that the thrift charter has run its course and should be phased out. We also recommend the creation of a federal charter for systemically important payment and settlement systems and that these systems should be overseen by the Federal Reserve, in order to guard the integrity of this vital part of our nation's economy.

When we released the Blueprint, I said that we were laying out a long-term vision that would not be implemented soon. Since then, the Bear Stearns episode and market turmoil more generally have placed in stark relief the outdated nature of our financial regulatory system, and has convinced me that we must move much more quickly to update our regulatory structure and improve both market oversight and market discipline. Over the last several weeks, I have recommended important steps that the United States should take in the near term, all of which move us toward the optimal regulatory structure outlined in the Blueprint. I will briefly summarize these.

First, Americans have come to expect the Federal Reserve to step in to avert events that pose unacceptable systemic risk. But the Fed does not have the clear statutory authority nor the mandate to do this; therefore we should consider how to most appropriately give the Federal Reserve the authority to access necessary information from complex financial institutions – whether it is a commercial bank, an investment bank, a hedge fund, or another type of financial institution – and the tools to intervene to mitigate systemic risk in advance of a crisis.

The MOU recently finalized between the SEC and the Federal Reserve is consistent with this long-term vision of the Blueprint and should help inform future decisions as our Congress considers how to modernize and improve our regulatory structure.

Market discipline is also critical to the health of our financial system, and must be reinforced, because regulation alone cannot eliminate all future bouts of market instability. For market discipline to be effective, market participants must not expect that lending from the Fed, or any other government support, is readily available. I know from first hand experience that normal or even presumed access to a government backstop has the potential to change behavior within financial institutions and with their creditors. It compromises market discipline and lowers risk premiums, ultimately putting the system at greater risk.

For market discipline to effectively constrain risk, financial institutions must be allowed to fail.

Today two concerns underpin expectations of regulatory intervention to prevent a failure. They are that an institution may be too interconnected to fail or too big to fail. Steps are being taken to improve market infrastructure, especially where our financial firms are highly intertwined - the OTC derivatives market and the tri-party repurchase agreement market, which is the marketplace through which our financial institutions obtain large amounts of secured funding.

It is clear that some institutions, if they fail, can have a systemic impact. Looking beyond immediate market challenges, last week I laid out my proposals for creating a resolution process that ensures the financial system can withstand the failure of a large complex financial firm. To do this, we will need to give our regulators additional emergency authority to limit temporary disruptions. These authorities should be flexible, and – to reinforce market discipline – the trigger for invoking such authority should be very high, such as a bankruptcy filing. Any potential commitment of government support should be an extraordinary event that requires

the engagement of the Treasury Department and contains sufficient criteria to prevent costs to the taxpayer to the greatest extent possible.

This work will not be done easily. It must begin now, and begin in earnest. Thank you.

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July 10, 2008
HP-1075

Treasury Targets Rami Makhluf's Companies

Washington - The U.S. Department of the Treasury today added Syriatel, Syria's largest mobile phone operator, and Ramak, a chain of Syrian duty free stores, to its Specially Designated Nationals and Blocked Persons List. All property and interests in property of these entities are blocked as a result of the direct or indirect ownership interest of at least 50 percent by Rami Makhluf in each entity.

"Rami Makhluf uses his access to high-level Syrian Government insiders to enrich himself at the expense of the Syrian people," said Adam J. Szubin, Director of the Office of Foreign Assets Control (OFAC). "We will continue to target Makhluf and his commercial empire as well as others who follow in his footsteps."

Makhluf was designated on February 21, 2008 pursuant to Executive Order 13460, which targets individuals and entities determined to have contributed to, or to have benefited from, the public corruption of senior officials of the Syrian regime.

Makhluf, a maternal cousin of Syrian president Bashar al-Asad, has exploited his relationships with Syrian regime members to amass his commercial empire. Makhluf has manipulated the Syrian judicial system and has used Syrian intelligence officials to intimidate business rivals.

Pursuant to E.O. 13460, any assets in Syriatel's or Ramak's names held in the United States or within the possession or control of U.S. persons are blocked, and U.S. persons, therefore, are prohibited from engaging in business or transactions with Syriatel or Ramak.

President George W. Bush issued E.O. 13460 on February 13, 2008 to take additional measures to address the threat to the national security, foreign policy, and economy of the United States posed by certain conduct of the Government of Syria.

This new authority builds on E.O. 13338, which was issued by President Bush in May 2004, by targeting activities that entrench and enrich the Syrian regime and its cohorts thereby enabling the regime to continue to engage in threatening behavior, including actions that undermine efforts to stabilize Iraq. Corruption by the regime also reinforces efforts that deny the people of

Syria political freedoms and economic prosperity, undercut peace and stability in the region, fund terrorism and violence, and undermine the sovereignty of Lebanon.

Identifying Information
RAMAK
AKAs:
Ramak Duty Free Shop Ltd
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Abu Ramana Street, Rawda, Damascus, Syria
Damascus Duty Free, Damascus International Airport, Damascus, Syria
Dara'a Duty Free, Naseeb Border Center, Dara'a, Syria

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Jdaideh Duty Free Complex, Jdaideh Yaboos, Damascus, Syria
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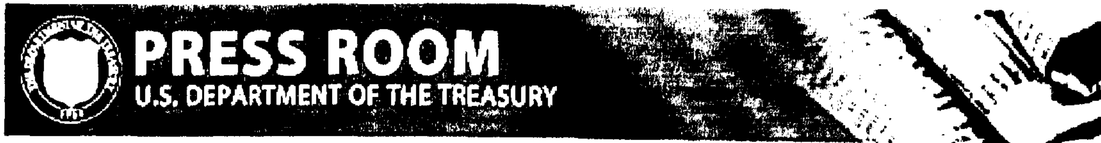

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July 10, 2008
hp-1076

Testimony of Treasury Deputy Assistant Secretary for International Tax Affairs Michael F. Mundaca Before the Senate Committee on Foreign Relations on Pending Income Tax Treaties

Washington, DC -- Mr. Chairman, Ranking Member Lugar, and distinguished Members of the Committee, I appreciate the opportunity to appear today to recommend, on behalf of the Administration, favorable action on three tax treaties pending before this Committee. We appreciate the Committee's interest in these treaties and in the U.S. tax treaty network overall.

This Administration is committed to eliminating barriers to cross-border trade and investment, and tax treaties are the primary means for eliminating tax barriers to such trade and investment. Tax treaties provide greater certainty to taxpayers regarding their potential liability to tax in foreign jurisdictions; they allocate taxing rights between the two jurisdictions and include other provisions that reduce the risk of double taxation, including provisions that reduce gross-basis withholding taxes; and they ensure that taxpayers are not subject to discriminatory taxation in the foreign jurisdiction.

This Administration is also committed to preventing tax evasion, and our tax treaties play an important role in this area as well. A key element of U.S. tax treaties is exchange of information between tax authorities. Under tax treaties, one country may request from the other such information as may be relevant for the proper administration of the first country's tax laws. Because access to information from other countries is critically important to the full and fair enforcement of U.S. tax laws, information exchange is a top priority for the United States in its tax treaty program.

A tax treaty reflects a balance of benefits that is agreed to when the treaty is negotiated. In some cases, changes in law or policy in one or both of the treaty partners make the partners more willing to increase the benefits beyond those provided by the treaty; in these cases, negotiation of a revised treaty may be very beneficial. In other cases, developments in one or both countries, or international developments more generally, may make is desirable to revisit a treaty to prevent exploitation of treaty provisions and eliminate unintended and inappropriate consequences in the application of the treaty; in these cases, it may be expedient to modify the agreement. Both in setting our overall negotiation priorities and in negotiating individual treaties, our focus is on ensuring that our tax treaty network fulfills its goals of facilitating cross border trade and investment and preventing fiscal evasion.

The treaties before the Committee today with Canada, Iceland, and Bulgaria serve to further the goals of our tax treaty network. The treaties with Canada and Iceland would modify existing tax treaty relationships. The tax treaty with Bulgaria would be the first between our two countries. We urge the Committee and the Senate to take prompt and favorable action on all of these agreements.

Before discussing the pending treaties in more detail, I would like to address some more general tax treaty matters, to provide background for the Committee's and the Senate's consideration of the pending tax treaties.

Purposes and Benefits of Tax Treaties

Tax treaties set out clear ground rules that govern tax matters relating to trade and

investment between the two countries.

One of the primary functions of tax treaties is to provide certainty to taxpayers regarding the threshold question with respect to international taxation: whether a taxpayer's cross-border activities will subject it to taxation by two or more countries. Tax treaties answer this question by establishing the minimum level of economic activity that must be engaged in within a country by a resident of the other before the first country may tax any resulting business profits. In general terms, tax treaties provide that if branch operations in a foreign country have sufficient substance and continuity, the country where those activities occur will have primary (but not exclusive) jurisdiction to tax. In other cases, where the operations in the foreign country are relatively minor, the home country retains the sole jurisdiction to tax.

Another primary function is relief of double taxation. Tax treaties protect taxpayers from potential double taxation primarily through the allocation of taxing rights between the two countries. This allocation takes several forms. First, the treaty has a mechanism for resolving the issue of residence in the case of a taxpayer that otherwise would be considered to be a resident of both countries. Second, with respect to each category of income, the treaty assigns the primary right to tax to one country, usually (but not always) the country in which the income arises (the "source" country), and the residual right to tax to the other country, usually (but not always) the country of residence of the taxpayer (the "residence" country). Third, the treaty provides rules for determining which country will be treated as the source country for each category of income. Finally, the treaty establishes the obligation of the residence country to eliminate double taxation that otherwise would arise from the exercise of concurrent taxing jurisdiction by the two countries.

In addition to reducing potential double taxation, tax treaties also reduce potential "excessive" taxation by reducing withholding taxes that are imposed at source. Under U.S. law, payments to non-U.S. persons of dividends and royalties as well as certain payments of interest are subject to withholding tax equal to 30 percent of the gross amount paid. Most of our trading partners impose similar levels of withholding tax on these types of income. This tax is imposed on a gross, rather than net, amount. Because the withholding tax does not take into account expenses incurred in generating the income, the taxpayer that bears the burden of withholding tax frequently will be subject to an effective rate of tax that is significantly higher than the tax rate that would be applicable to net income in either the source or residence country. The taxpayer may be viewed, therefore, as suffering excessive taxation. Tax treaties alleviate this burden by setting maximum levels for the withholding tax that the treaty partners may impose on these types of income or by providing for exclusive residence-country taxation of such income through the elimination of source-country withholding tax. Because of the excessive taxation that withholding taxes can represent, the United States seeks to include in tax treaties provisions that substantially reduce or eliminate source-country withholding taxes.

As a complement to these substantive rules regarding allocation of taxing rights, tax treaties provide a mechanism for dealing with disputes between the countries regarding the treaties, including questions regarding the proper application of the treaties that arise after the treaty enters into force. To resolve disputes, designated tax authorities of the two governments – known as the "competent authorities" in tax treaty parlance – are to consult and to endeavor to reach agreement. Under many such agreements, the competent authorities agree to allocate a taxpayer's income between the two taxing jurisdictions on a consistent basis, thereby preventing the double taxation that might otherwise result. The U.S. competent authority under our tax treaties is the Secretary of the Treasury. That function has been delegated to the Deputy Commissioner (International) of the Large and Mid-Size Business Division of the Internal Revenue Service.

Tax treaties also include provisions intended to ensure that cross-border investors do not suffer discrimination in the application of the tax laws of the other country. This is similar to a basic investor protection provided in other types of agreements, but the non-discrimination provisions of tax treaties are specifically tailored to tax matters and, therefore, are the most effective means of addressing potential discrimination in the tax context. The relevant tax treaty provisions explicitly prohibit types of discriminatory measures that once were common in some tax systems. At the same time, tax treaties clarify the manner in which possible discrimination is to be tested in the tax context.

In addition to these core provisions, tax treaties include provisions dealing with

more specialized situations, such as rules coordinating the pension rules of the tax systems of the two countries or addressing the treatment of Social Security benefits and alimony and child-support payments in the cross-border context. These provisions are becoming increasingly important as more individuals move between countries or otherwise are engaged in cross-border activities. While these matters may not involve substantial tax revenue from the perspective of the two governments, rules providing clear and appropriate treatment are very important to the affected taxpayers.

Tax treaties also include provisions related to tax administration. A key element of U.S. tax treaties is the provision addressing the exchange of information between the tax authorities. Under tax treaties, the competent authority of one country may request from the other competent authority such information as may be relevant for the proper administration of the first country's tax laws; the information provided pursuant to the request is subject to the strict confidentiality protections that apply to taxpayer information. Because access to information from other countries is critically important to the full and fair enforcement of the U.S. tax laws, information exchange is a priority for the United States in its tax treaty program. If a country has bank-secrecy rules that would operate to prevent or seriously inhibit the appropriate exchange of information under a tax treaty, we will not enter into a new tax treaty relationship with that country. Indeed, the need for appropriate information exchange provisions is one of the treaty matters that we consider non-negotiable.

Tax Treaty Negotiating Priorities and Process

The United States has a network of 58 income tax treaties covering 66 countries. This network covers the vast majority of foreign trade and investment of U.S. businesses and investors. In establishing our negotiating priorities, our primary objective is the conclusion of tax treaties that will provide the greatest benefit to the United States and to U.S. taxpayers. We communicate regularly with the U.S. business community and the Internal Revenue Service, seeking input regarding the areas in which treaty network expansion and improvement efforts should be focused and seeking information regarding practical problems encountered under particular treaties and particular tax regimes.

The primary constraint on the size of our tax treaty network may be the complexity of the negotiations themselves. Ensuring that the various functions to be performed by tax treaties are all properly taken into account makes the negotiation process exacting and time consuming.

Numerous features of a country's particular tax legislation and its interaction with U.S. domestic tax rules must be considered in negotiating a treaty or protocol. Examples include whether the country eliminates double taxation through an exemption system or a credit system, the country's treatment of partnerships and other transparent entities, and how the country taxes contributions to pension funds, earnings of the funds, and distributions from the funds.

Moreover, a country's fundamental tax policy choices are reflected not only in its tax legislation but also in its tax treaty positions. These choices differ significantly from country to country, with substantial variation even across countries that seem to have quite similar economic profiles. A treaty negotiation must take into account all of these aspects of the particular treaty partner's tax system and treaty policies to arrive at an agreement that accomplishes the United States' tax treaty objectives.

Obtaining the agreement of our treaty partners on provisions of importance to the United States sometimes requires concessions on our part. Similarly, the other country sometimes must make concessions to obtain our agreement on matters that are critical to it. Each treaty that we present to the Senate represents not only the best deal that we believe can be achieved with the particular country, but also constitutes an agreement that we believe is in the best interests of the United States.

In some situations, the right result may be no tax treaty at all. Prospective treaty partners must evidence a clear understanding of what their obligations would be under the treaty, especially those with respect to information exchange, and must demonstrate that they would be able to fulfill those obligations. Sometimes a tax treaty may not be appropriate because a potential treaty partner is unable to do so.

In other cases, a tax treaty may be inappropriate because the potential treaty partner is not willing to agree to particular treaty provisions that are needed to address real tax problems that have been identified by U.S. businesses operating there or because the potential treaty partner insists on provisions the United States will not agree to, such as providing a U.S. tax credit for investment in the foreign country (so-called "tax sparing"). With other countries there simply may not be the type of cross-border tax issues that are best resolved by treaty. For example, if a country does not impose significant income taxes, there is little possibility of double taxation of cross-border income, and an agreement that is focused on the exchange of tax information ("tax information exchange agreements" or TIEAs) may be the most appropriate agreement.

A high priority for improving our overall treaty network is continued focus on prevention of "treaty shopping." The U.S. commitment to including comprehensive limitation on benefits provisions is one of the keys to improving our overall treaty network. Our tax treaties are intended to provide benefits to residents of the United States and residents of the particular treaty partner on a reciprocal basis. The reductions in source-country taxes agreed to in a particular treaty mean that U.S. persons pay less tax to that country on income from their investments there and residents of that country pay less U.S. tax on income from their investments in the United States. Those reductions and benefits are not intended to flow to residents of a third country. If third-country residents are able to exploit one of our tax treaties to secure reductions in U.S. tax, such as through the use of an entity resident in a treaty country that merely holds passive U.S. assets, the benefits would flow only in one direction as third-country residents would enjoy U.S. tax reductions for their U.S. investments, but U.S. residents would not enjoy reciprocal tax reductions for their investments in that third country. Moreover, such third-country residents may be securing benefits that are not appropriate in the context of the interaction between their home country's tax systems and policies and those of the United States. This use of tax treaties is not consistent with the balance of the deal negotiated in the underlying tax treaty. Preventing this exploitation of our tax treaties is critical to ensuring that the third country will sit down at the table with us to negotiate on a reciprocal basis, so we can secure for U.S. persons the benefits of reductions in source-country tax on their investments in that country.

Consideration of Arbitration

Tax treaties cannot facilitate cross-border investment and provide a more stable investment environment unless the treaty is effectively implemented by the tax administrations of the two countries. Under our tax treaties, when a U.S. taxpayer becomes concerned about implementation of the treaty, the taxpayer can bring the matter to the U.S. competent authority who will seek to resolve the matter with the competent authority of the treaty partner. The competent authorities will work cooperatively to resolve genuine disputes as to the appropriate application of the treaty.

The U.S. competent authority has a good track record in resolving disputes. Even in the most cooperative bilateral relationships, however, there will be instances in which the competent authorities will not be able to reach a timely and satisfactory resolution. Moreover, as the number and complexity of cross-border transactions increases, so does the number and complexity of cross-border tax disputes. Accordingly, we have considered ways to equip the U.S. competent authority with additional tools to resolve disputes promptly, including the possible use of arbitration in the competent authority mutual agreement process.

The first U.S. tax agreement that contemplated arbitration was the U.S.-Germany income tax treaty signed in 1989. Tax treaties with several other countries, including Canada, Mexico, and the Netherlands, incorporate authority for establishing voluntary binding arbitration procedures based on the provision in the prior U.S.-Germany treaty. Although we believe that the presence of these voluntary arbitration provisions may have provided some limited assistance in reaching mutual agreements, it has become clear that the ability to enter into voluntary arbitration does not provide sufficient incentive to resolve problem cases in a timely fashion.

Over the past few years, we have carefully considered and studied various types of mandatory arbitration procedures that could be used as part of the competent authority mutual agreement process. In particular, we examined the experience of countries that adopted mandatory binding arbitration provisions with respect to tax

matters. Many of them report that the prospect of impending mandatory arbitration creates a significant incentive to compromise before commencement of the process. Based on our review of the U.S. experience with arbitration in other areas of the law, the success of other countries with arbitration in the tax area, and the overwhelming support of the business community, we concluded that mandatory binding arbitration as the final step in the competent authority process can be an effective and appropriate tool to facilitate mutual agreement under U.S. tax treaties.

One of the treaties before the Committee, the Protocol with Canada, includes a type of mandatory arbitration provision negotiated contemporaneously with, and very similar to, a provision in our current, recently ratified treaties with Germany and Belgium, which this Committee and the Senate considered last year.

In the typical competent authority mutual agreement process, a U.S. taxpayer presents its problem to the U.S. competent authority and participates in formulating the position the U.S. competent authority will take in discussions with the treaty partner. Under the arbitration provision proposed in the Canadian protocol, as in the similar provisions that are now part of our treaties with Germany and Belgium, if the competent authorities cannot resolve the issue within two years, the competent authorities must present the issue to an arbitration board for resolution, unless both competent authorities agree that the case is not suitable for arbitration. The arbitration board must resolve the issue by choosing the position of one of the competent authorities. That position is adopted as the agreement of the competent authorities and is treated like any other mutual agreement (*i.e.*, one that has been negotiated by the competent authorities) under the treaty.

Because the arbitration board can only choose between the positions of each competent authority, the expectation is that the differences between the positions of the competent authorities will tend to narrow as the case moves closer to arbitration. In fact, if the arbitration provision is successful, difficult issues will be resolved without resort to arbitration. Thus, it is our expectation that these arbitration provisions will be rarely utilized, but that their presence will encourage the competent authorities to take approaches to their negotiations that result in mutually agreed conclusions in the first instance.

The arbitration process proposed in the agreement with Canada, consistent with the German and Belgian provisions, is mandatory and binding with respect to the competent authorities. However, consistent with the negotiation process under the mutual agreement procedure, the taxpayer can terminate the arbitration at any time by withdrawing its request for competent authority assistance. Moreover, the taxpayer retains the right to litigate the matter (in the United States or the treaty partner) in lieu of accepting the result of the arbitration, just as it would be entitled to litigate in lieu of accepting the result of a negotiation under the mutual agreement procedure.

Arbitration is a growing and developing field, and there are many forms of arbitration from which to choose. We intend to continue to study other arbitration provisions and to monitor the performance of the provisions in the agreements with Belgium and Germany, as well as the performance of the provision in the agreement with Canada, if ratified. We look forward to continuing to work with the Committee to make arbitration an effective tool in promoting the fair and expeditious resolution of treaty disputes. The Committee's comments made with respect to the German and Belgian arbitration provisions have been very helpful and will inform future negotiations of arbitration provisions.

Discussion of Proposed Treaties

I now would like to discuss in more detail the three treaties that have been transmitted for the Senate's consideration. We have submitted a Technical Explanation of each treaty that contains detailed discussions of the provisions of each treaty. These Technical Explanations serve as an official guide to each treaty. The Technical Explanation to the Protocol with Canada was reviewed by Canada, and Canada subscribes to its contents, as will be confirmed by a press release from the Canadian Ministry of Finance.

Canada

The proposed Protocol with Canada was signed in Chelsea on September 21,

2007, and is the fifth protocol of amendment to the current Convention negotiated in 1980 and amended by prior protocols in 1983, 1984, 1995, and 1997. The most significant provisions in this treaty relate to the taxation of cross-border interest, the treatment of income derived through fiscally transparent entities, the taxation of certain provisions of services, and the adoption of mandatory arbitration to facilitate the resolution of disputes between the U.S. and Canadian revenue authorities. The proposed Protocol also makes a number of changes to reflect changes in U.S. and Canadian law, and to bring the current Convention into closer conformity with current U.S. tax treaty policy.

The proposed Protocol eliminates withholding taxes on cross-border interest payments. The elimination of withholding taxes on all cross-border interest payments between the United States and Canada has been a top tax treaty priority for both the business community and the Treasury Department for many years. The proposed Protocol represents a substantial improvement over the current Convention, which generally provides for a source-country withholding tax rate of 10 percent. This provision would be effective for interest paid to unrelated parties on the first day of January of the year in which the proposed Protocol enters into force, and it would be phased in for interest paid to related persons over a three-year period. Consistent with U.S. tax treaty policy, the proposed Protocol also provides exceptions to the elimination of source-country taxation with respect to contingent interest and payments from a U.S. real estate mortgage investment conduit.

The proposed Protocol also would provide that a U.S. person is generally eligible to claim the benefits of the treaty when such person derives income through an entity that is considered by the United States to be fiscally transparent (*e.g.*, a partnership) unless the entity is a Canadian entity and is not treated by Canada as fiscally transparent. The proposed Protocol in addition contains anti-abuse provisions intended to address certain situations involving the use of these entities to obtain treaty benefits inappropriately.

The current Convention generally limits the taxation by one country of the business profits of a resident of the other country. The source country's right to tax such profits is generally limited to cases in which the profits are attributable to a permanent establishment located in that country. The proposed Protocol would add provisions related to the taxation of permanent establishments. Most importantly, the proposed Protocol includes a special rule allowing source-country taxation of income from certain provisions of services not otherwise considered to be provided through a permanent establishment. This rule is broader than the permanent establishment rule in the U.S. Model tax treaty but was key to achieving an overall agreement that we believe is in the best interests of the United States and U.S. taxpayers.

As previously noted, the proposed Protocol provides for mandatory arbitration of certain cases that have not been resolved by the competent authority within a specified period, generally two years from the commencement of the case. Under the proposed Protocol, the arbitration process may be used to reach an agreement with respect to certain issues relating to residence, permanent establishment, business profits, related persons, and royalties. The arbitration board must deliver a determination within six months of the appointment of the chair of the arbitration board, and the determination must either be the proposed resolution submitted by the United States or the proposed resolution submitted by Canada. The board's determination has no precedential value and the board shall not provide a rationale for its determination.

The proposed Protocol also makes a number of other modifications to the current Convention to reflect changes to U.S. law and current U.S. tax treaty policy. For example, the proposed Protocol updates the current Convention's treatment of pensions for cross-border workers to remove barriers to the flow of personal services between the United States and Canada that could otherwise result from discontinuities in the laws of the two countries regarding the tax treatment of pensions. In addition, the proposed Protocol updates the current Convention's limitation on benefits provisions so that they apply on a reciprocal basis. The proposed Protocol also addresses the treatment of companies that engages in corporate "continuance" transactions and revises the current Convention's rules regarding the residence of so-called dual resident companies.

The proposed Protocol provides that the United States and Canada shall notify

each other in writing, through diplomatic channels, when their respective applicable procedures for ratification have been satisfied. The proposed Protocol will enter into force upon the date of the later of the required notifications. For taxes withheld at source, it will generally have effect for amounts paid or credited on or after the first day of the second month that begins after the date the proposed Protocol enters into force, although certain provisions with respect to interest may have earlier effect. With respect to other taxes, the proposed Protocol will generally have effect for taxable years that begin after the calendar year in which the proposed Protocol enters into force. Certain provisions will be phased in or have a delayed effective date. Provisions regarding corporate continuance transactions will apply retroactively, consistent with prior Treasury Department public statements.

Iceland

The proposed Convention and accompanying Protocol with Iceland was signed in Washington, D.C., on October 23, 2007. It would replace the current Convention, concluded in 1975. The most important change from the current Convention is the addition of a limitation on benefits provision. The proposed Convention also makes changes to some of the withholding tax rates provided in the current Convention. In addition, the proposed Convention makes a number of changes to reflect changes in U.S. and Icelandic law, and to conform to current U.S. tax treaty policy.

As just noted, the proposed Convention contains a comprehensive limitation on benefits provision, generally following the current U.S. Model income tax treaty. The current Convention does not contain treaty shopping protections and, as a result, has been abused by third-country investors in recent years. For this reason, revising the current Convention has been a top tax treaty priority.

The proposed Convention generally provides for withholding rates on investment income that are the same as or lower than those in the current Convention. Like the current Convention, the proposed Convention provides for reduced source-country taxation of cross-border dividends. In addition, the proposed Convention would eliminate source-country withholding tax on cross-border dividend payments to pension funds. As with the current Convention, the proposed Convention generally would eliminate source-country withholding tax on cross-border interest payments. However, while the current Convention eliminates source-country withholding taxes on all cross-border payments of royalties, the proposed Convention would allow the country in which certain cross-border trademark royalties arise to impose a withholding tax of up to 5 percent. Inclusion of this provision was key to achieving an overall agreement that we believe is in the best interests of the United States and U.S. taxpayers.

In addition, the proposed Convention provides for the exchange between the tax authorities of each country of information relevant to carrying out the provisions of the agreement or the domestic tax laws of either country.

The proposed Convention provides that the United States and Iceland shall notify each other in writing, through diplomatic channels, when their respective applicable procedures for ratification have been satisfied. The proposed Convention will enter into force on the date of the later of the required notifications. It will have effect, with respect to taxes withheld at source, for amounts paid or credited on or after the first day of January of the calendar year following entry into force, and with respect to other taxes, for taxable years beginning on or after the first day of January following the date upon which the proposed Convention enters into force. The current Convention will, with respect to any tax, cease to have effect as of the date on which this proposed Convention has effect with respect to such tax. However, where any person would be entitled to greater benefits under the current Convention, at the election of the person, the current Convention shall continue to have effect in its entirety with respect to such person for a period of 12 months from the date the provisions of the proposed Convention are effective.

Bulgaria

The proposed income tax Convention and accompanying Protocol with Bulgaria signed in Washington, D.C., on February 23, 2007, and the subsequent Protocol with Bulgaria signed in Sofia, on February 26, 2008, together would represent the first income tax treaty between the United States and Bulgaria. The proposed Convention is generally consistent with the current U.S. Model income tax treaty and with treaties that the United States has with other countries.

Under the proposed Convention, withholding taxes on cross-border portfolio dividend payments may be imposed by the source state at a maximum rate of 10 percent. When the beneficial owner of a cross-border dividend is a company that directly owns at least 10 percent of the stock of the company paying the dividend, withholding tax may be imposed at a maximum rate of 5 percent. The proposed Convention also provides for a withholding rate of zero on cross-border dividend payments to pension funds.

The proposed Convention generally limits withholding taxes on cross-border interest payments to a maximum rate of 5 percent. No withholding tax on a cross-border interest payment is generally permitted, however, when the interest is beneficially owned by, or guaranteed by, the government or the central bank of the other country (or any institution owned by that country), a pension fund resident in the other country, or a financial institution (including a bank or an insurance company) resident in the other country.

The proposed Convention provides that withholding taxes on cross-border royalty payments are limited to a maximum rate of 5 percent.

The proposed Convention also incorporates rules provided in the U.S. Model tax treaty for certain classes of investment income. For example, dividends paid by entities such as U.S. regulated investment companies and real estate investment trusts, are subject to special rules to prevent the use of these entities to transform what is otherwise higher-taxed income into lower-taxed income.

The proposed Convention limits the taxation by one country of the business profits of a resident of the other country. The source country's right to tax such profits is generally limited to cases in which the profits are attributable to a permanent establishment located in that country. The proposed Convention includes a rule, similar to a rule in the proposed Protocol with Canada, allowing source-country taxation of income from certain provisions of services. The proposed Convention also provides that certain employees or agents that maintain a stock of goods from which the agent regularly fills orders on behalf of the principal, and conduct additional activities contributing to the conclusion of sales, may result in a permanent establishment.

Consistent with current U.S. tax treaty policy, the proposed Convention includes a comprehensive limitation on benefits article, which is designed to deny treaty shoppers the benefits of the Convention. The proposed Convention provides for non-discriminatory treatment by one country to residents and nationals of the other country. In addition, the proposed Convention provides for the exchange between the tax authorities of each country of information relevant to carrying out the provisions of the agreement or the domestic tax laws of either country. This will facilitate the enforcement of U.S. domestic tax rules.

The proposed Convention provides that the United States and Bulgaria shall notify each other, through diplomatic channels, when their respective applicable procedures for ratification have been satisfied. The proposed Convention will enter into force upon the date of receipt of the later of the required notifications. It will have effect, with respect to taxes withheld at source, for amounts paid or credited on or after the first day of January in the year following the date upon which the proposed Convention enters into force and, with respect to other taxes, for taxable years beginning on or after the first day of January in the year following the date upon which the proposed Convention enters into force.

Treaty Program Priorities

A key continuing priority for the Treasury Department is updating the few remaining U.S. tax treaties that provide for low withholding tax rates but do not include the limitation on benefits provisions needed to protect against the possibility of treaty shopping. Accordingly, we currently are in ongoing discussions with both Poland and Hungary regarding the inclusion of anti-treaty shopping provisions.

In addition, we continue to maintain a very active calendar of tax treaty negotiations. We recently initialed a new tax treaty with Malta. We also are currently negotiating with France and New Zealand, and expect to announce soon the opening of other negotiations.

We also have undertaken exploratory discussions with several countries in Asia and South America that we hope will lead to productive negotiations later in 2008 or in 2009.

Conclusion

Mr. Chairman and Ranking Member Lugar, let me conclude by thanking you for the opportunity to appear before the Committee to discuss the Administration's efforts with respect to the three agreements under consideration. We appreciate the Committee's continuing interest in the tax treaty program, and we thank the Members and staff for devoting time and attention to the review of these new agreements. We are also grateful for the assistance and cooperation of the staff of the Joint Committee on Taxation.

On behalf of the Administration, we urge the Committee to take prompt and favorable action on the agreements before you today. I would be happy to respond to any question you may have.

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REPORTS

- Canada Technical Explanation
- Iceland Technical Explanation
- Bulgaria Technical Explanation

DEPARTMENT OF THE TREASURY

TECHNICAL EXPLANATION OF

THE PROTOCOL DONE AT CHELSEA ON SEPTEMBER 21, 2007

AMENDING THE CONVENTION BETWEEN

THE UNITED STATES OF AMERICA AND CANADA

WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL

DONE AT WASHINGTON ON SEPTEMBER 26, 1980,

AS AMENDED BY THE PROTOCOLS DONE ON

JUNE 14, 1983, MARCH 28, 1994, MARCH 17, 1995, AND JULY 29, 1997

INTRODUCTION

This is a Technical Explanation of the Protocol signed at Chelsea on September 21, 2007 (the "Protocol"), amending the Convention between the United States of America and Canada with Respect to Taxes on Income and on Capital done at Washington on September 26, 1980, as amended by the Protocols done on June 14, 1983, March 28, 1994, March 17, 1995, and July 29, 1997 (the "existing Convention"). The existing Convention as modified by the Protocol shall be referred to as the "Convention."

Negotiation of the Protocol took into account the U.S. Treasury Department's current tax treaty policy and the Treasury Department's Model Income Tax Convention, published on November 15, 2006 (the "U.S. Model"). Negotiations also took into account the Model Tax Convention on Income and on Capital, published by the Organisation for Economic Cooperation and Development (the "OECD Model"), and recent tax treaties concluded by both countries.

The Technical Explanation is an official United States guide to the Protocol. The Government of Canada has reviewed this document and subscribes to its contents. In the view of both governments, this document accurately reflects the policies behind particular Protocol provisions, as well as understandings reached with respect to the application and interpretation of the Protocol and the Convention.

References made to the "existing Convention" are intended to put various provisions of the Protocol into context. The Technical Explanation does not, however, provide a complete comparison between the provisions of the existing Convention and the amendments made by the Protocol. The Technical Explanation is not intended to provide a complete guide to the existing Convention as amended by the Protocol. To the extent that the existing Convention has not been amended by the Protocol, the prior technical explanations of the Convention remain the official explanations. References in this Technical Explanation to "he"' or "his" should be read to mean "he or she" or "his or her." References to the "Code" are to the Internal Revenue Code.

On the date of signing of the Protocol, the United States and Canada exchanged two sets of diplomatic notes. Each of these notes sets forth provisions and understandings related to the Protocol and the Convention, and comprises an integral part of the overall agreement between the United States and Canada. The first note, the

"Arbitration Note," relates to the implementation of new paragraphs 6 and 7 of Article XXVI (Mutual Agreement Procedure), which provide for binding arbitration of certain disputes between the competent authorities. The second note, the "General Note," relates more generally to issues of interpretation or application of various provisions of the Protocol.

Article 1

Article 1 of the Protocol adds subparagraph 1(k) to Article III (General Definitions) to address the definition of "national" of a Contracting State as used in the Convention. The Contracting States recognize that Canadian tax law does not draw distinctions based on nationality as such. Nevertheless, at the request of the United States, the definition was added and contains references to both citizenship and nationality. The definition includes any individual possessing the citizenship or nationality of a Contracting State and any legal person, partnership or association whose status is determined by reference to the laws in force in a Contracting State. The existing Convention contains one reference to the term "national" in paragraph 1 of Article XXVI (Mutual Agreement Procedure). The Protocol adds another reference in paragraph 1 of Article XXV (Non-Discrimination) to ensure that nationals of the United States are covered by the non-discrimination provisions of the Convention. The definition added by the Protocol is consistent with the definition provided in other U.S. tax treaties.

The General Note provides that for purposes of paragraph 2 of Article III, as regards the application at any time of the Convention, any term not defined in the Convention shall, unless the context otherwise requires or the competent authorities otherwise agree to a common meaning pursuant to Article XXVI (Mutual Agreement Procedure), have the meaning which it has at that time under the law of that State for the purposes of the taxes to which the Convention apply, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

Article 2

Article 2 of the Protocol replaces paragraph 3 of Article IV (Residence) of the existing Convention to address the treatment of so-called dual resident companies. Article 2 of the Protocol also adds new paragraphs 6 and 7 to Article IV to determine whether income is considered to be derived by a resident of a Contracting State when such income is derived through a fiscally transparent entity.

Paragraph 3 of Article IV – Dual resident companies

Paragraph 3, which addresses companies that are otherwise considered resident in each of the Contracting States, is replaced. The provisions of paragraph 3, and the date upon which these provisions are effective, are consistent with an understanding reached between the United States and Canada on September 18, 2000, to clarify the residence of a company under the Convention when the company has engaged in a so-called corporate "continuance" transaction. The paragraph applies only where, by reason of the rules set forth in paragraph 1 of Article IV (Residence), a company is a resident of both Contracting States.

Subparagraph 3(a) provides a rule to address the situation when a company is a resident of both Contracting States but is created under the laws in force in only one of the Contracting States. In such a case, the rule provides that the company is a resident only of the Contracting State under which it is created. For example, if a company is incorporated in the United States but the company is also otherwise considered a resident

of Canada because the company is managed in Canada, subparagraph 3(a) provides that the company shall be considered a resident only of the United States for purposes of the Convention. Subparagraph 3(a) is intended to operate in a manner similar to the first sentence of former paragraph 3. However, subparagraph 3(a) clarifies that such a company must be considered created in only one of the Contracting States to fall within the scope of subparagraph 3(a). In some cases, a company may engage in a corporate continuance transaction and retain its charter in the Contracting State from which it continued, while also being considered as created in the State to which the company continued. In such cases, the provisions of subparagraph 3(a) shall not apply because the company would be considered created in both of the Contracting States.

Subparagraph 3(b) addresses all cases involving a dual resident company that are not addressed in subparagraph 3(a). Thus, subparagraph 3(b) applies to continuance transactions occurring between the Contracting States if, as a result, a company otherwise would be considered created under the laws of each Contracting State, *e.g.*, because the corporation retained its charter in the first State. Subparagraph 3(b) would also address so-called serial continuance transactions where, for example, a company continues from one of the Contracting States to a third country and then continues into the other Contracting State without having ceased to be treated as resident in the first Contracting State.

Subparagraph 3(b) provides that if a company is considered to be a resident of both Contracting States, and the residence of such company is not resolved by subparagraph 3(a), then the competent authorities of the Contracting States shall endeavor to settle the question of residency by a mutual agreement procedure and determine the mode of application of the Convention to such company. Subparagraph 3(b) also provides that in the absence of such agreement, the company shall not be considered a resident of either Contracting State for purposes of claiming any benefits under the Convention.

Paragraphs 6 and 7 of Article IV – income, profit, or gain derived through fiscally transparent entities

New paragraphs 6 and 7 are added to Article IV to provide specific rules for the treatment of amounts of income, profit or gain derived through or paid by fiscally transparent entities such as partnerships and certain trusts. Fiscally transparent entities, as explained more fully below, are in general entities the income of which is taxed at the beneficiary, member, or participant level. Entities that are subject to tax, but with respect to which tax may be relieved under an integrated system, are not considered fiscally transparent entities. Entities that are fiscally transparent for U.S. tax purposes include partnerships, common investment trusts under section 584, grantor trusts, and business entities such as a limited liability company ("LLC") that is treated as a partnership or is disregarded as an entity separate from its owner for U.S. tax purposes. Entities falling within this description in Canada are (except to the extent the law provides otherwise) partnerships and what are known as "bare" trusts.

United States tax law also considers a corporation that has made a valid election to be taxed under Subchapter S of Chapter 1 of the Internal Revenue Code (an "S corporation") to be fiscally transparent within the meaning explained below. Thus, if a U.S. resident derives income from Canada through an S corporation, the U.S. resident will under new paragraph 6 be considered for purposes of the Convention as the person who derived the income. Exceptionally, because Canada will ordinarily accept that an S corporation is itself resident in the United States for purposes of the Convention, Canada will allow benefits under the Convention to the S corporation in its own right. In a

reverse case, however – that is, where the S corporation is owned by a resident of Canada and has U.S.-source income, profits or gains – the Canadian resident will not be considered as deriving the income by virtue of subparagraph 7 (a) as Canada does not see the S corporation as fiscally transparent.

Under both paragraph 6 and paragraph 7, it is relevant whether the treatment of an amount of income, profit or gain derived by a person through an entity under the tax law of the residence State is "the same as its treatment would be if that amount had been derived directly." For purposes of paragraphs 6 and 7, whether the treatment of an amount derived by a person through an entity under the tax law of the residence State is the same as its treatment would be if that amount had been derived directly by that person shall be determined in accordance with the principles set forth in Code section 894 and the regulations under that section concerning whether an entity will be treated as fiscally transparent with respect to an item of income received by the entity. Treas. Reg. section 1.894-1(d)(3)(iii) provides that an entity will be fiscally transparent under the laws of an interest holder's jurisdiction with respect to an item of income to the extent that the laws of that jurisdiction require the interest holder resident in that jurisdiction to separately take into account on a current basis the interest holder's respective share of the item of income paid to the entity, whether or not distributed to the interest holder, and the character and source of the item in the hands of the interest holder are determined as if such item were realized directly from the source from which realized by the entity. Although Canada does not have analogous provisions in its domestic law, it is anticipated that principles comparable to those described above will apply.

Paragraph 6

Under paragraph 6, an amount of income, profit or gain is considered to be derived by a resident of a Contracting State (residence State) if 1) the amount is derived by that person through an entity (other than an entity that is a resident of the other Contracting State (source State), and 2) by reason of that entity being considered fiscally transparent under the laws of the residence State, the treatment of the amount under the tax law of the residence State is the same as its treatment would be if that amount had been derived directly by that person. These two requirements are set forth in subparagraphs 6(a) and 6(b), respectively.

For example, if a U.S. resident owns a French entity that earns Canadian-source dividends and the entity is considered fiscally transparent under U.S. tax law, the U.S. resident is considered to derive the Canadian-source dividends for purposes of Article IV (and thus, the dividends are considered as being "paid to" the resident) because the U.S. resident is considered under the tax law of the United States to have derived the dividend through the French entity and, because the entity is treated as fiscally transparent under U.S. tax law, the treatment of the income under U.S. tax law is the same as its treatment would be if that amount had been derived directly by the U.S. resident. This result obtains even if the French entity is viewed differently under the tax laws of Canada or of France (*i.e.*, the French entity is treated under Canadian law or under French tax law as not fiscally transparent).

Similarly, if a Canadian resident derives U.S.-source income, profit or gain through an entity created under Canadian law that is considered a partnership for Canadian tax purposes but a corporation for U.S. tax purposes, U.S.-source income, profit or gain derived through such entity by the Canadian resident will be considered to be derived by the Canadian resident in considering the application of the Convention.

Application of paragraph 6 and related treaty provisions by Canada

In determining the entitlement of a resident of the United States to the benefits of the Convention, Canada shall apply the Convention within its own legal framework.

For example, assume that from the perspective of Canadian law an amount of income is seen as being paid from a source in Canada to USLLC, an entity that is entirely owned by U.S. persons and is fiscally transparent for U.S. tax purposes, but that Canada considers a corporation and, thus, under Canadian law, a taxpayer in its own right. Since USLLC is not itself taxable in the United States, it is not considered to be a U.S. resident under the Convention; but for new paragraph 6 Canada would not apply the Convention in taxing the income.

If new paragraph 6 applies in respect of an amount of income, profit or gain, such amount is considered as having been derived by one or more U.S. resident shareholders of USLLC, and Canada shall grant benefits of the Convention to the payment to USLLC and eliminate or reduce Canadian tax as provided in the Convention. The effect of the rule is to suppress Canadian taxation of USLLC to give effect to the benefits available under the Convention to the U.S. residents in respect of the particular amount of income, profit or gain.

However, for Canadian tax purposes, USLLC remains the only "visible" taxpayer in relation to this amount. In other words, the Canadian tax treatment of this taxpayer (USLLC) is modified because of the entitlement of its U.S. resident shareholders to benefits under the Convention, but this does not alter USLLC's status under Canadian law. Canada does not, for example, treat USLLC as though it did not exist, substituting the shareholders for it in the role of taxpayer under Canada's system.

Some of the implications of this are as follows. First, Canada will not require the shareholders of USLLC to file Canadian tax returns in respect of income that benefits from new paragraph 6. Instead, USLLC itself will file a Canadian tax return in which it will claim the benefit of the paragraph and supply any documentation required to support the claim. (The Canada Revenue Agency will supply additional practical guidance in this regard, including instructions for seeking to establish entitlement to Convention benefits in advance of payment.) Second, as is explained in greater detail below, if the income in question is business profits, it will be necessary to determine whether the income was earned through a permanent establishment in Canada. This determination will be based on the presence and activities in Canada of USLLC itself, not of its shareholders acting in their own right.

Determination of the existence of a permanent establishment from the business activities of a fiscally transparent entity

New paragraph 6 applies not only in respect of amounts of dividends, interest and royalties, but also profit (business income), gains and other income. It may thus be relevant in cases where a resident of one Contracting State carries on business in the other State through an entity that has a different characterization in each of the two Contracting States.

Application of new paragraph 6 and the provisions of Article V (Permanent Establishment) by Canada

Assume, for instance, that a resident of the United States is part owner of a U.S. limited liability company (USLLC) that is treated in the United States as a fiscally

transparent entity, but in Canada as a corporation. Assume one of the other two shareholders of USLLC is resident in a country that does not have a tax treaty with Canada and that the remaining shareholder is resident in a country with which Canada does have a tax treaty, but that the treaty does not include a provision analogous to paragraph 6.

Assume further that USLLC carries on business in Canada, but does not do so through a permanent establishment there. (Note that from the Canadian perspective, the presence or absence of a permanent establishment is evaluated with respect to USLLC only, which Canada sees as a potentially taxable entity in its own right.) Regarding Canada's application of the provisions of the Convention, the portion of USLLC's profits that belongs to the U.S. resident shareholder will not be taxable in Canada, provided that the U.S. resident meets the Convention's limitation on benefits provisions. Under paragraph 6, that portion is seen as having been derived by the U.S. resident shareholder, who is entitled to rely on Article VII (Business Profits). The balance of USLLC's profits will, however, remain taxable in Canada. Since USLLC is not itself resident in the United States for purposes of the Convention, in respect of that portion of its profits that is not considered to have been derived by a U.S. resident (or a resident of another country whose treaty with Canada includes a rule comparable to paragraph 6) it is not relevant whether or not it has a permanent establishment in Canada.

Another example would be the situation where a USLLC that is wholly owned by a resident of the U.S. carries on business in Canada through a permanent establishment. If the USLLC is fiscally transparent for U.S. tax purposes (and therefore, the conditions for the application of paragraph 6 are satisfied) then the USLLC's profits will be treated as having been derived by its U.S. resident owner inclusive of all attributes of that income (*e.g.*, such as having been earned through a permanent establishment). However, since the USLLC remains the only "visible" taxpayer for Canadian tax purposes, it is the USLLC, and not the U.S. shareholder, that is subject to tax on the profits that are attributable to the permanent establishment.

Application of new paragraph 6 and the provisions of Article V (Permanent Establishment) by the United States

It should be noted that in the situation where a person is considered to derive income through an entity, the United States looks in addition to such person's activities in order to determine whether he has a permanent establishment. Assume that a Canadian resident and a resident in a country that does not have a tax treaty with the United States are owners of CanLP. Assume further that Can LP is an entity that is considered fiscally transparent for Canadian tax purposes but is not considered fiscally transparent for U.S. tax purposes, and that CanLP carries on business in the United States. If CanLP carries on the business through a permanent establishment, that permanent establishment may be attributed to the partners. Moreover, in determining whether there is a permanent establishment, the activities of both the entity and its partners will be considered. If CanLP does not carry on the business through a permanent establishment, the Canadian resident, who derives income through the partnership, may claim the benefits of Article VII (Business Profits) of the Convention with respect to such income, assuming that the income is not otherwise attributable to a permanent establishment of the partner. In any case, the third country partner cannot claim the benefits of Article VII of the Convention between the United States and Canada.

Paragraph 7

Paragraph 7 addresses situations where an item of income, profit or gain is considered not to be paid to or derived by a person who is a resident of a Contracting State. The paragraph is divided into two subparagraphs.

Under subparagraph 7(a), an amount of income, profit or gain is considered not to be paid to or derived by a person who is a resident of a Contracting State (the residence State) if (1) the other Contracting State (the source State) views the person as deriving the amount through an entity that is not a resident of the residence State, and (2) by reason of the entity not being treated as fiscally transparent under the laws of the residence State, the treatment of the amount under the tax law of the residence State is not the same as its treatment would be if that amount had been derived directly by the person.

For example, assume USCo, a company resident in the United States, is a part owner of CanLP, an entity that is considered fiscally transparent for Canadian tax purposes, but is not considered fiscally transparent for U.S. tax purposes. CanLP receives a dividend from a Canadian company in which it owns stock. Under Canadian tax law USCo is viewed as deriving a Canadian-source dividend through CanLP. For U.S. tax purposes, CanLP, and not USCo, is viewed as deriving the dividend. Because the treatment of the dividend under U.S. tax law in this case is not the same as the treatment under U.S. law if USCo derived the dividend directly, subparagraph 7(a) provides that USCo will not be considered as having derived the dividend. The result would be the same if CanLP were a third-country entity that was viewed by the United States as not fiscally transparent, but was viewed by Canada as fiscally transparent. Similarly, income from U.S. sources received by an entity organized under the laws of the United States that is treated for Canadian tax purposes as a corporation and is owned by shareholders who are residents of Canada is not considered derived by the shareholders of that U.S. entity even if, under U.S. tax law, the entity is treated as fiscally transparent.

Subparagraph 7(b) provides that an amount of income, profit or gain is not considered to be paid to or derived by a person who is a resident of a Contracting State (the residence State) where the person is considered under the tax law of the other Contracting State (the source State) to have received the amount from an entity that is a resident of that other State (the source State), but by reason of the entity being treated as fiscally transparent under the laws of the Contracting State of which the person is resident (the residence State), the treatment of such amount under the tax law of that State (the residence State) is not the same as the treatment would be if that entity were not treated as fiscally transparent under the laws of that State (the residence State).

That is, under subparagraph 7(b), an amount of income, profit or gain is not considered to be paid to or derived by a resident of a Contracting State (the residence State) if: (1) the other Contracting State (the source State) views such person as receiving the amount from an entity resident in the source State; (2) the entity is viewed as fiscally transparent under the laws of the residence State; and (3) by reason of the entity being treated as fiscally transparent under the laws of the residence State, the treatment of the amount received by that person under the tax law of the residence State is not the same as its treatment would be if the entity were not treated as fiscally transparent under the laws of the residence State.

For example, assume that USCo, a company resident in the United States is the sole owner of CanCo, an entity that is considered under Canadian tax law to be a

corporation that is resident in Canada but is considered under U.S. tax law to be disregarded as an entity separate from its owner. Assume further that USCo is considered under Canadian tax law to have received a dividend from CanCo.

In such a case, Canada, the source State, views USCo as receiving income (*i.e.*, a dividend) from a corporation that is a resident of Canada (CanCo), CanCo is viewed as fiscally transparent under the laws of the United States, the residence State, and by reason of CanCo being disregarded under U.S. tax law, the treatment under U.S. tax law of the payment is not the same as its treatment would be if the entity were regarded as a corporation under U.S. tax law. That is, the payment is disregarded for U.S. tax purposes, whereas if U.S. tax law regarded CanCo as a corporation, the payment would be treated as a dividend. Therefore, subparagraph 7(b) would apply to provide that the income is not considered to be paid to or derived by USCo.

The same result obtains if, in the above example, USCo is considered under Canadian tax law to have received an interest or royalty payment (instead of a dividend) from CanCo. Under U.S. law, because CanCo is disregarded as an entity separate from its owner, the payment is disregarded, whereas if CanCo were treated as not fiscally transparent, the payment would be treated as interest or a royalty, as the case may be. Therefore, subparagraph 7(b) would apply to provide that such amount is not considered to be paid to or derived by USCo.

The application of subparagraph 7(b) differs if, in the above example, USCo (as well as other persons) are owners of CanCo, a Canadian entity that is considered under Canadian tax law to be a corporation that is resident in Canada but is considered under U.S. tax law to be a partnership (as opposed to being disregarded). Assume that USCo is considered under Canadian tax law to have received a dividend from CanCo. Such payment is viewed under Canadian tax law as a dividend, but under U.S. tax law is viewed as a partnership distribution. In such a case, Canada views USCo as receiving income (*i.e.*, a dividend) from an entity that is a resident of Canada (CanCo), CanCo is viewed as fiscally transparent under the laws of the United States, the residence State, and by reason of CanCo being treated as a partnership under U.S. tax law, the treatment under U.S. tax law of the payment (as a partnership distribution) is not the same as the treatment would be if CanCo were not fiscally transparent under U.S. tax law (as a dividend). As a result, subparagraph 7(b) would apply to provide that such amount is not considered paid to or derived by the U.S. resident.

As another example, assume that CanCo, a company resident in Canada, is the owner of USLP, an entity that is considered under U.S. tax law (by virtue of an election) to be a corporation resident in the United States, but that is considered under Canadian tax law to be a branch of CanCo. Assume further that CanCo is considered under U.S. tax law to have received a dividend from USLP. In this case, the United States views CanCo as receiving income (*i.e.*, a dividend) from an entity that is resident in the United States (USLP), but by reason of USLP being a branch under Canadian tax law, the treatment under Canadian tax law of the payment is not the same as its treatment would be if USLP were a company under Canadian tax law. That is, the payment is treated as a branch remittance for Canadian tax purposes, whereas if Canadian tax law regarded USLP as a corporation, the payment would be treated as a dividend. Therefore, subparagraph 7(b) would apply to provide that the income is not considered to be paid to or derived by CanCo. The same result would obtain in the case of interest or royalties paid by USLP to CanCo.

Paragraphs 6 and 7 apply to determine whether an amount is considered to be derived by (or paid to) a person who is a resident of Canada or the United States. If, as a

result of paragraph 7, a person is not considered to have derived or received an amount of income, profit or gain, that person shall not be entitled to the benefits of the Convention with respect to such amount. Additionally, for purposes of application of the Convention by the United States, the treatment of such payments under Code section 894(c) and the regulations thereunder would not be relevant.

New paragraphs 6 and 7 are not an exception to the saving clause of paragraph 2 of Article XXIX (Miscellaneous Rules). Accordingly, subparagraph 7(b) does not prevent a Contracting State from taxing an entity that is treated as a resident of that State under its tax law. For example, if a U.S. partnership with members who are residents of Canada elects to be taxed as a corporation for U.S. tax purposes, the United States will tax that partnership on its worldwide income on a net basis, even if Canada views the partnership as fiscally transparent.

Interaction of paragraphs 6 and 7 with the determination of "beneficial ownership"

With respect to payments of income, profits or gain arising in a Contracting State and derived directly by a resident of the other Contracting State (and not through a fiscally transparent entity), the term "beneficial owner" is defined under the internal law of the country imposing tax (*i.e.*, the source State). Thus, if the payment arising in a Contracting State is derived by a resident of the other State who under the laws of the first-mentioned State is determined to be a nominee or agent acting on behalf of a person that is not a resident of that other State, the payment will not be entitled to the benefits of the Convention. However, payments arising in a Contracting State and derived by a nominee on behalf of a resident of that other State would be entitled to benefits. These limitations are confirmed by paragraph 12 of the Commentary to Article 10 of the OECD Model.

Special rules apply in the case of income, profits or gains derived through a fiscally transparent entity, as described in new paragraph 6 of Article IV. Residence State principles determine who derives the income, profits or gains, to assure that the income, profits or gains for which the source State grants benefits of the Convention will be taken into account for tax purposes by a resident of the residence State. Source country principles of beneficial ownership apply to determine whether the person who derives the income, profits or gains, or another resident of the other Contracting State, is the beneficial owner of the income, profits or gains. The source State may conclude that the person who derives the income, profits or gains in the residence State is a mere nominee, agent, conduit, etc., for a third country resident and deny benefits of the Convention. If the person who derives the income, profits or gains under paragraph 6 of Article IV would not be treated under the source State's principles for determining beneficial ownership as a nominee, agent, custodian, conduit, etc., that person will be treated as the beneficial owner of the income, profits or gains for purposes of the Convention.

Assume, for instance, that interest arising in the United States is paid to CanLP, an entity established in Canada which is treated as fiscally transparent for Canadian tax purposes but is treated as a company for U.S. tax purposes. CanCo, a company incorporated in Canada, is the sole interest holder in CanLP. Paragraph 6 of Article IV provides that CanCo derives the interest. However, if under the laws of the United States regarding payments to nominees, agents, custodians and conduits, CanCo is found be a nominee, agent, custodian or conduit for a person who is not a resident of Canada, CanCo will not be considered the beneficial owner of the interest and will not be entitled to the benefits of Article XI with respect to such interest. The payment may be entitled to

benefits, however, if CanCo is found to be a nominee, agent, custodian or conduit for a person who is a resident of Canada.

With respect to Canadian-source income, profit or gains, beneficial ownership is to be determined under Canadian law. For example, assume that LLC, an entity that is treated as fiscally transparent for U.S. tax purposes, but as a corporation for Canadian tax purposes, is owned by USCo, a U.S. resident company. LLC receives Canadian-source income. The question of the beneficial ownership of the income received by LLC is determined under Canadian law. If LLC is considered the beneficial owner of the income under Canadian law, paragraph 6 shall apply to extend benefits of the Convention to the income received by LLC to the extent that the Canadian-source income is derived by U.S. resident members of LLC.

Article 3

Article 3 of the Protocol amends Article V (Permanent Establishment) of the Convention. Paragraph 1 of Article 3 of the Protocol adds a reference in Paragraph 6 of Article IV to new paragraph 9 of Article V. Paragraph 2 of Article 3 of the Protocol sets forth new paragraphs 9 and 10 of Article V.

Paragraph 9 of Article V

New paragraph 9 provides a special rule (subject to the provisions of paragraph 3) for an enterprise of a Contracting State that provides services in the other Contracting State, but that does not have a permanent establishment by virtue of the preceding paragraphs of the Article. If (and only if) such an enterprise meets either of two tests as provided in subparagraphs 9(a) and 9(b), the enterprise will be deemed to provide those services through a permanent establishment in the other State.

The first test as provided in subparagraph 9(a) has two parts. First, the services must be performed in the other State by an individual who is present in that other State for a period or periods aggregating 183 days or more in any twelve-month period. Second, during that period or periods, more than 50 percent of the gross active business revenues of the enterprise (including revenue from active business activities unrelated to the provision of services) must consist of income derived from the services performed in that State by that individual. If the enterprise meets both of these tests, the enterprise will be deemed to provide the services through a permanent establishment. This test is employed to determine whether an enterprise is deemed to have a permanent establishment by virtue of the presence of a single individual (*i.e.*, a natural person).

For the purposes of subparagraph 9(a), the term "gross active business revenues" shall mean the gross revenues attributable to active business activities that the enterprise has charged or should charge for its active business activities, regardless of when the actual billing will occur or of domestic law rules concerning when such revenues should be taken into account for tax purposes. Such active business activities are not restricted to the activities related to the provision of services. However, the term does not include income from passive investment activities.

As an example of the application of subparagraph 9(a), assume that Mr. X, an individual resident in the United States, is one of the two shareholders and employees of USCo, a company resident in the United States that provides engineering services. During the 12-month period beginning December 20 of Year 1 and ending December 19 of Year 2, Mr. X is present in Canada for periods totaling 190 days, and during those

periods, 70 percent of all of the gross active business revenues of USCo attributable to business activities are derived from the services that Mr. X performs in Canada. Because both of the criteria of subparagraph 9(a) are satisfied, USCo will be deemed to have a permanent establishment in Canada by virtue of that subparagraph.

The second test as provided in subparagraph 9(b) provides that an enterprise will have a permanent establishment if the services are provided in the other State for an aggregate of 183 days or more in any twelve-month period with respect to the same or connected projects for customers who either are residents of the other State or maintain a permanent establishment in the other State with respect to which the services are provided. The various conditions that have to be satisfied in order for subparagraph 9(b) to have application are described in detail below.

In addition to meeting the 183-day threshold, the services must be provided for customers who either are residents of the other State or maintain a permanent establishment in that State. The intent of this requirement is to reinforce the concept that unless there is a customer in the other State, such enterprise will not be deemed as participating sufficiently in the economic life of that other State to warrant being deemed to have a permanent establishment.

Assume for example, that CanCo, a Canadian company, wishes to acquire USCo, a company in the United States. In preparation for the acquisition, CanCo hires Canlaw, a Canadian law firm, to conduct a due diligence evaluation of USCo's legal and financial standing in the United States. Canlaw sends a staff attorney to the United States to perform the due diligence analysis of USCo. That attorney is present and working in the United States for greater than 183 days. If the remuneration paid to Canlaw for the attorney's services does not constitute more than 50 percent of Canlaw's gross active business revenues for the period during which the attorney is present in the United States, Canlaw will not be deemed to provide the services through a permanent establishment in the United States by virtue of subparagraph 9(a). Additionally, because the services are being provided for a customer (CanCo) who neither is a resident of the United States nor maintains a permanent establishment in the United States to which the services are provided, Canlaw will also not have a permanent establishment in the United States by virtue of subparagraph 9(b).

Paragraph 9 applies only to the provision of services, and only to services provided by an enterprise to third parties. Thus, the provision does not have the effect of deeming an enterprise to have a permanent establishment merely because services are provided to that enterprise. Paragraph 9 only applies to services that are performed or provided by an enterprise of a Contracting State within the other Contracting State. It is therefore not sufficient that the relevant services be merely furnished to a resident of the other Contracting State. Where, for example, an enterprise provides customer support or other services by telephone or computer to customers located in the other State, those would not be covered by paragraph 9 because they are not performed or provided by that enterprise within the other State. Another example would be that of an architect who is hired to design blueprints for the construction of a building in the other State. As part of completing the project, the architect must make site visits to that other State, and his days of presence there would be counted for purposes of determining whether the 183-day threshold is satisfied. However, the days that the architect spends working on the blueprint in his home office shall not count for purposes of the 183-day threshold, because the architect is not performing or providing those services within the other State.

For purposes of determining whether the time threshold has been met, subparagraph 9(b) permits the aggregation of services that are provided with respect to

connected projects. Paragraph 2 of the General Note provides that for purposes of subparagraph 9(b), projects shall be considered to be connected if they constitute a coherent whole, commercially and geographically. The determination of whether projects are connected should be determined from the point of view of the enterprise (not that of the customer), and will depend on the facts and circumstances of each case. In determining the existence of commercial coherence, factors that would be relevant include: 1) whether the projects would, in the absence of tax planning considerations, have been concluded pursuant to a single contract; 2) whether the nature of the work involved under different projects is the same; and 3) whether the same individuals are providing the services under the different projects. Whether the work provided is covered by one or multiple contracts may be relevant, but not determinative, in finding that projects are commercially coherent.

The aggregation rule addresses, for example, potentially abusive situations in which work has been artificially divided into separate components in order to avoid meeting the 183-day threshold. Assume for example, that a technology consultant has been hired to install a new computer system for a company in the other country. The work will take ten months to complete. However, the consultant purports to divide the work into two five-month projects with the intention of circumventing the rule in subparagraph 9(b). In such case, even if the two projects were considered separate, they will be considered to be commercially coherent. Accordingly, subject to the additional requirement of geographic coherence, the two projects could be considered to be connected, and could therefore be aggregated for purposes of subparagraph 9(b). In contrast, assume that the technology consultant is contracted to install a particular computer system for a company, and is also hired by that same company, pursuant to a separate contract, to train its employees on the use of another computer software that is unrelated to the first system. In this second case, even though the contracts are both concluded between the same two parties, there is no commercial coherence to the two projects, and the time spent fulfilling the two contracts may not be aggregated for purposes of subparagraph 9(b). Another example of projects that do not have commercial coherence would be the case of a law firm which, as one project provides tax advice to a customer from one portion of its staff, and as another project provides trade advice from another portion of its staff, both to the same customer.

Additionally, projects, in order to be considered connected, must also constitute a geographic whole. An example of projects that lack geographic coherence would be a case in which a consultant is hired to execute separate auditing projects at different branches of a bank located in different cities pursuant to a single contract. In such an example, while the consultant's projects are commercially coherent, they are not geographically coherent and accordingly the services provided in the various branches shall not be aggregated for purposes of applying subparagraph 9(b). The services provided in each branch should be considered separately for purposes of subparagraph 9(b).

The method of counting days for purposes of subparagraph 9(a) differs slightly from the method for subparagraph 9(b). Subparagraph 9(a) refers to days in which an individual is present in the other country. Accordingly, physical presence during a day is sufficient. In contrast, subparagraph 9(b) refers to days during which services are provided by the enterprise in the other country. Accordingly, non-working days such as weekends or holidays would not count for purposes of subparagraph 9(b), as long as no services are actually being provided while in the other country on those days. For the purposes of both subparagraphs, even if the enterprise sends many individuals simultaneously to the other country to provide services, their collective presence during one calendar day will count for only one day of the enterprise's presence in the other

country. For instance, if an enterprise sends 20 employees to the other country to provide services to a client in the other country for 10 days, the enterprise will be considered present in the other country only for 10 days, not 200 days (20 employees x 10 days).

By deeming the enterprise to provide services through a permanent establishment in the other Contracting State, paragraph 9 allows the application of Article VII (Business Profits), and accordingly, the taxation of the services shall be on a net-basis. Such taxation is also limited to the profits attributable to the activities carried on in performing the relevant services. It will be important to ensure that only the profits properly attributable to the functions performed and risks assumed by provision of the services will be attributed to the deemed permanent establishment.

In addition to new paragraph 9, Article 3 of the Protocol amends paragraph 6 of Article V of the Convention to include a reference to paragraph 9. Therefore, in no case will paragraph 9 apply to deem services to be provided through a permanent establishment if the services are limited to those mentioned in paragraph 6 which, if performed through a fixed place of business, would not make the fixed place of business a permanent establishment under the provisions of that paragraph.

The competent authorities are encouraged to consider adopting rules to reduce the potential for excess withholding or estimated tax payments with respect to employee wages that may result from the application of this paragraph. Further, because paragraph 6 of Article V applies notwithstanding paragraph 9, days spent on preparatory or auxiliary activities shall not be taken into account for purposes of applying subparagraph 9(b).

Paragraph 10 of Article V

Paragraph 2 of Article 3 of the Protocol also sets forth new paragraph 10 of Article V. The provisions of new paragraph 10 are identical to paragraph 9 of Article V as it existed prior to the Protocol. New paragraph 10 provides that the provisions of Article V shall be applied in determining whether any person has a permanent establishment in any State.

Article 4

Article 4 of the Protocol replaces paragraph 2 of Article VII (Business Profits).

New paragraph 2 provides that where a resident of either Canada or the United States carries on (or has carried on) business in the other Contracting State through a permanent establishment in that other State, both Canada and the United States shall attribute to permanent establishments in their respective states those business profits which the permanent establishment might be expected to make if it were a distinct and separate person engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the resident and with any other person related to the resident. The term "related to the resident" is to be interpreted in accordance with paragraph 2 of Article IX (Related Persons). The reference to other related persons is intended to make clear that the test of paragraph 2 is not restricted to independence between a permanent establishment and a home office.

New paragraph 2 is substantially similar to paragraph 2 as it existed before the Protocol. However, in addition to the reference to a resident of a Contracting State who "carries on" business in the other Contracting State, the Protocol incorporates into the Convention the rule of Code section 864(c)(6) by adding "or has carried on" to address

circumstances where, as a result of timing, income may be attributable to a permanent establishment that no longer exists in one of the Contracting States. In such cases, the income is properly within the scope of Article VII. Conforming changes are also made in the Protocol to Articles X (Dividends), XI (Interest), and XII (Royalties) of the Convention where Article VII would apply. As is explained in paragraph 5 of the General Note, these revisions to the Convention are only intended to clarify the application of the existing provisions of the Convention.

The following example illustrates the application of paragraph 2. Assume a company that is a resident of Canada and that maintains a permanent establishment in the United States winds up the permanent establishment's business and sells the permanent establishment's inventory and assets to a U.S. buyer at the end of year 1 in exchange for an installment obligation payable in full at the end of year 3. Despite the fact that the company has no permanent establishment in the United States in year 3, the United States may tax the deferred income payment recognized by the company in year 3.

The "attributable to" concept of paragraph 2 provides an alternative to the analogous but somewhat different "effectively connected" concept in Code section 864(c). Depending on the circumstances, the amount of income "attributable to" a permanent establishment under Article VII may be greater or less than the amount of income that would be treated as "effectively connected" to a U.S. trade or business under Code section 864. In particular, in the case of financial institutions, the use of internal dealings to allocate income within an enterprise may produce results under Article VII that are significantly different than the results under the effectively connected income rules. For example, income from interbranch notional principal contracts may be taken into account under Article VII, notwithstanding that such transactions may be ignored for purposes of U.S. domestic law. A taxpayer may use the treaty to reduce its taxable income, but may not use both treaty and Code rules where doing so would thwart the intent of either set of rules. *See* Rev. Rul. 84-17, 1984-1 C.B. 308.

The profits attributable to a permanent establishment may be from sources within or without a Contracting State. However, as stated in the General Note, the business profits attributable to a permanent establishment include only those profits derived from the assets used, risks assumed, and activities performed by the permanent establishment.

The language of paragraph 2, when combined with paragraph 3 dealing with the allowance of deductions for expenses incurred for the purposes of earning the profits, incorporates the arm's length standard for purposes of determining the profits attributable to a permanent establishment. The United States and Canada generally interpret the arm's length standard in a manner consistent with the OECD Transfer Pricing Guidelines.

Paragraph 9 of the General Note confirms that the arm's length method of paragraphs 2 and 3 consists of applying the OECD Transfer Pricing Guidelines, but taking into account the different economic and legal circumstances of a single legal entity (as opposed to separate but associated enterprises). Thus, any of the methods used in the Transfer Pricing Guidelines, including profits methods, may be used as appropriate and in accordance with the Transfer Pricing Guidelines. However, the use of the Transfer Pricing Guidelines applies only for purposes of attributing profits within the legal entity. It does not create legal obligations or other tax consequences that would result from transactions having independent legal significance. Thus, the Contracting States agree that the notional payments used to compute the profits that are attributable to a permanent establishment will not be taxed as if they were actual payments for purposes of other taxing provisions of the Convention, for example, for purposes of taxing a notional royalty under Article XII (Royalties).

One example of the different circumstances of a single legal entity is that an entity that operates through branches rather than separate subsidiaries generally will have lower capital requirements because all of the assets of the entity are available to support all of the entity's liabilities (with some exceptions attributable to local regulatory restrictions). This is the reason that most commercial banks and some insurance companies operate through branches rather than subsidiaries. The benefit that comes from such lower capital costs must be allocated among the branches in an appropriate manner. This issue does not arise in the case of an enterprise that operates through separate entities, since each entity will have to be separately capitalized or will have to compensate another entity for providing capital (usually through a guarantee).

Under U.S. domestic regulations, internal "transactions" generally are not recognized because they do not have legal significance. In contrast, the rule provided by the General Note is that such internal dealings may be used to attribute income to a permanent establishment in cases where the dealings accurately reflect the allocation of risk within the enterprise. One example is that of global trading in securities. In many cases, banks use internal swap transactions to transfer risk from one branch to a central location where traders have the expertise to manage that particular type of risk. Under paragraph 2 as set forth in the Protocol, such a bank may also use such swap transactions as a means of attributing income between the branches, if use of that method is the "best method" within the meaning of regulation section 1.482-1(c). The books of a branch will not be respected, however, when the results are inconsistent with a functional analysis. So, for example, income from a transaction that is booked in a particular branch (or home office) will not be treated as attributable to that location if the sales and risk management functions that generate the income are performed in another location.

The understanding in the General Note also affects the interpretation of paragraph 3 of Article VII. Paragraph 3 provides that in determining the business profits of a permanent establishment, deductions shall be allowed for the expenses incurred for the purposes of the permanent establishment, ensuring that business profits will be taxed on a net basis. This rule is not limited to expenses incurred exclusively for the purposes of the permanent establishment, but includes expenses incurred for the purposes of the enterprise as a whole, or that part of the enterprise that includes the permanent establishment. Deductions are to be allowed regardless of which accounting unit of the enterprise books the expenses, so long as they are incurred for the purposes of the permanent establishment. For example, a portion of the interest expense recorded on the books of the home office in one State may be deducted by a permanent establishment in the other. The amount of the expense that must be allowed as a deduction is determined by applying the arm's length principle.

As noted above, paragraph 9 of the General Note provides that the OECD Transfer Pricing Guidelines apply, by analogy, in determining the profits attributable to a permanent establishment. Accordingly, a permanent establishment may deduct payments made to its head office or another branch in compensation for services performed for the benefit of the branch. The method to be used in calculating that amount will depend on the terms of the arrangements between the branches and head office. For example, the enterprise could have a policy, expressed in writing, under which each business unit could use the services of lawyers employed by the head office. At the end of each year, the costs of employing the lawyers would be charged to each business unit according to the amount of services used by that business unit during the year. Since this has the characteristics of a cost-sharing arrangement and the allocation of costs is based on the benefits received by each business unit, such a cost allocation would be an acceptable

means of determining a permanent establishment's deduction for legal expenses. Alternatively, the head office could agree to employ lawyers at its own risk, and to charge an arm's length price for legal services performed for a particular business unit. If the lawyers were under-utilized, and the "fees" received from the business units were less than the cost of employing the lawyers, then the head office would bear the excess cost. If the "fees" exceeded the cost of employing the lawyers, then the head office would keep the excess to compensate it for assuming the risk of employing the lawyers. If the enterprise acted in accordance with this agreement, this method would be an acceptable alternative method for calculating a permanent establishment's deduction for legal expenses.

The General Note also makes clear that a permanent establishment cannot be funded entirely with debt, but must have sufficient capital to carry on its activities as if it were a distinct and separate enterprise. To the extent that the permanent establishment has not been attributed capital for profit attribution purposes, a Contracting State may attribute such capital to the permanent establishment, in accordance with the arm's length principle, and deny an interest deduction to the extent necessary to reflect that capital attribution. The method prescribed by U.S. domestic law for making this attribution is found in Treas. Reg. section 1.882-5. Both section 1.882-5 and the method prescribed in the General Note start from the premise that all of the capital of the enterprise supports all of the assets and risks of the enterprise, and therefore the entire capital of the enterprise must be allocated to its various businesses and offices.

However, section 1.882-5 does not take into account the fact that some assets create more risk for the enterprise than do other assets. An independent enterprise would need less capital to support a perfectly-hedged U.S. Treasury security than it would need to support an equity security or other asset with significant market and/or credit risk. Accordingly, in some cases section 1.882-5 would require a taxpayer to allocate more capital to the United States, and therefore would reduce the taxpayer's interest deduction more, than is appropriate. To address these cases, the General Note allows a taxpayer to apply a more flexible approach that takes into account the relative risk of its assets in the various jurisdictions in which it does business. In particular, in the case of financial institutions other than insurance companies, the amount of capital attributable to a permanent establishment is determined by allocating the institution's total equity between its various offices on the basis of the proportion of the financial institution's risk-weighted assets attributable to each of them. This recognizes the fact that financial institutions are in many cases required to risk-weight their assets for regulatory purposes and, in other cases, will do so for business reasons even if not required to do so by regulators. However, risk-weighting is more complicated than the method prescribed by section 1.882-5. Accordingly, to ease this administrative burden, taxpayers may choose to apply the principles of Treas. Reg. section 1.882-5(c) to determine the amount of capital allocable to its U.S. permanent establishment, in lieu of determining its allocable capital under the risk-weighted capital allocation method provided by the General Note, even if it has otherwise chosen the principles of Article VII rather than the effectively connected income rules of U.S. domestic law. It is understood that this election is not binding for purposes of Canadian taxation unless the result is in accordance with the arm's length principle.

As noted in the Convention, nothing in paragraph 3 requires a Contracting State to allow the deduction of any expenditure which, by reason of its nature, is not generally allowed as a deduction under the tax laws in that State.

Article 5

Article 5 makes a number of amendments to Article X (Dividends) of the existing Convention. As with other benefits of the Convention, the benefits of Article X are available to a resident of a Contracting State only if that resident is entitled to those benefits under the provisions of Article XXIX A (Limitation on Benefits).

See the Technical Explanation for new paragraphs 6 and 7 of Article IV (Residence) for discussion regarding the interaction between domestic law concepts of beneficial ownership and the treaty rules to determine when a person is considered to derive an item of income for purposes of obtaining benefits of the Convention such as withholding rate reductions.

Paragraph 1

Paragraph 1 of Article 5 of the Protocol replaces subparagraph 2(a) of Article X of the Convention. In general, paragraph 2 limits the amount of tax that may be imposed on dividends by the Contracting State in which the company paying the dividends is resident if the beneficial owner of the dividends is a resident of the other Contracting State. Subparagraph 2(a) limits the rate to 5 percent of the gross amount of the dividends if the beneficial owner is a company that owns 10 percent or more of the voting stock of the company paying the dividends.

The Protocol adds a parenthetical to address the determination of the requisite ownership set forth in subparagraph 2(a) when the beneficial owner of dividends receives the dividends through an entity that is considered fiscally transparent in the beneficial owner's Contracting State. The added parenthetical stipulates that voting stock in a company paying the dividends that is indirectly held through an entity that is considered fiscally transparent in the beneficial owner's Contracting State is taken into account, provided the entity is not a resident of the other Contracting State. The United States views the new parenthetical as merely a clarification.

For example, assume USCo, a U.S. corporation, directly owns 2 percent of the voting stock of CanCo, a Canadian company that is considered a corporation in the United States and Canada. Further, assume that USCo owns 18 percent of the interests in LLC, an entity that in turn owns 50 percent of the voting stock of CanCo. CanCo pays a dividend to each of its shareholders. Provided that LLC is fiscally transparent in the United States and not considered a resident of Canada, USCo's 9 percent ownership in CanCo through LLC (50 percent x 18 percent) is taken into account in determining whether USCo meets the 10 percent ownership threshold set forth in subparagraph 2(a). In this example, USCo may aggregate its voting stock interests in CanCo that it owns directly and through LLC to determine if it satisfies the ownership requirement of subparagraph 2(a). Accordingly, USCo will be entitled to the 5 percent rate of withholding on dividends paid with respect to both its voting stock held through LLC and its voting stock held directly. Alternatively, if, for example, all of the shareholders of LLC were natural persons, the 5 percent rate would not apply.

Paragraph 2

Paragraph 2 of Article 5 of the Protocol replaces the definition of the term "dividends" provided in paragraph 3 of Article X of the Convention. The new definition conforms to the U.S. Model formulation. Paragraph 3 defines the term dividends broadly and flexibly. The definition is intended to cover all arrangements that yield a return on

an equity investment in a corporation as determined under the tax law of the source State, as well as arrangements that might be developed in the future.

The term dividends includes income from shares, or other corporate rights that are not treated as debt under the law of the source State, that participate in the profits of the company. The term also includes income that is subjected to the same tax treatment as income from shares by the law of the source State. Thus, for example, a constructive dividend that results from a non-arm's length transaction between a corporation and a related party is a dividend. In the case of the United States the term "dividend" includes amounts treated as a dividend under U.S. law upon the sale or redemption of shares or upon a transfer of shares in a reorganization. *See, e.g.*, Rev. Rul. 92-85, 1992-2 C.B. 69 (sale of foreign subsidiary's stock to U.S. sister company is a deemed dividend to extent of the subsidiary's and sister company's earnings and profits). Further, a distribution from a U.S. publicly traded limited partnership that is taxed as a corporation under U.S. law is a dividend for purposes of Article X. However, a distribution by a limited liability company is not considered by the United States to be a dividend for purposes of Article X, provided the limited liability company is not characterized as an association taxable as a corporation under U.S. law.

Paragraph 3 of the General Note states that distributions from Canadian income trusts and royalty trusts that are treated as dividends as a result of changes to Canada's taxation of income and royalty trusts enacted in 2007 (S.C. 2007, c. 29) shall be treated as dividends for the purposes of Article X.

Additionally, a payment denominated as interest that is made by a thinly capitalized corporation may be treated as a dividend to the extent that the debt is recharacterized as equity under the laws of the source State. At the time the Protocol was signed, interest payments subject to Canada's thin-capitalization rules were not recharacterized as dividends.

Paragraph 3

Paragraph 3 of Article 5 of the Protocol replaces paragraph 4 of Article X. New paragraph 4 is substantially similar to paragraph 4 as it existed prior to the Protocol. New paragraph 4, however, adds clarifying language consistent with the changes made in Articles 4, 6, and 7 of the Protocol with respect to income attributable to a permanent establishment that has ceased to exist. Paragraph 4 provides that the limitations of paragraph 2 do not apply if the beneficial owner of the dividends carries on or has carried on business in the State in which the company paying the dividends is a resident through a permanent establishment situated there, and the stockholding in respect of which the dividends are paid is effectively connected to such permanent establishment. In such a case, the dividends are taxable pursuant to the provisions of Article VII (Business Profits). Thus, dividends paid in respect of holdings forming part of the assets of a permanent establishment or which are otherwise effectively connected to such permanent establishment 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 is situated.

To conform with Article 9 of the Protocol, which deletes Article XIV (Independent Personal Services) of the Convention, paragraph 4 of Article 5 of the Protocol also amends paragraph 5 of Article X by omitting the reference to a "fixed base."

Paragraph 4

To conform with Article 9 of the Protocol, which deletes Article XIV (Independent Personal Services) of the Convention, paragraph 4 of Article 5 of the Protocol amends paragraph 5 of Article X by omitting the reference to a "fixed base."

Paragraph 5

Paragraph 5 of Article 5 of the Protocol replaces subparagraph 7(c) of Article X of the existing Convention. Consistent with current U.S. tax treaty policy, new subparagraph 7(c) provides rules that expand the application of subparagraph 2(b) for the treatment of dividends paid by a Real Estate Investment Trust (REIT). New subparagraph 7(c) maintains the rule of the existing Convention that dividends paid by a REIT are not eligible for the 5 percent maximum rate of withholding tax of subparagraph 2(a), and provides that the 15 percent maximum rate of withholding tax of subparagraph 2(b) applies to dividends paid by REITs only if one of three conditions is met.

First, the dividend will qualify for the 15 percent maximum rate if the beneficial owner of the dividend is an individual holding an interest of not more than 10 percent in the REIT. For this purpose, subparagraph 7(c) also provides that where an estate or testamentary trust acquired its interest in a REIT as a consequence of the death of an individual, the estate or trust will be treated as 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.

Second, the dividend will qualify for the 15 percent maximum rate if it is paid with respect to a class of stock that is publicly traded and the beneficial owner of the dividend is a person holding an interest of not more than 5 percent of any class of the REIT's stock.

Third, the dividend will qualify for the 15 percent maximum rate if the beneficial owner of the dividend holds an interest in the REIT of 10 percent or less and the REIT is "diversified." A REIT is diversified if the gross value of no single interest in real property held by the REIT exceeds 10 percent of the gross value of the REIT's total interest in real property. For purposes of this diversification test, foreclosure property is not considered an interest in real property, and a REIT holding a partnership interest is treated as owning its proportionate share of any interest in real property held by the partnership.

A resident of Canada directly holding U.S. real property would pay U.S. tax either at a 30 percent rate of withholding tax on the gross income or at graduated rates on the net income. By placing the real property in a REIT, the investor absent a special rule could transform real estate income into dividend income, taxable at the rates provided in Article X, significantly reducing the U.S. tax that otherwise would be imposed. Subparagraph 7(c) prevents this result and thereby avoids a disparity between the taxation of direct real estate investments and real estate investments made through REIT conduits. In the cases in which subparagraph 7(c) allows a dividend from a REIT to be eligible for the 15 percent maximum rate of withholding tax, the holding in the REIT is not considered the equivalent of a direct holding in the underlying real property.

Article 6

Article 6 of the Protocol replaces Article XI (Interest) of the existing Convention. Article XI specifies the taxing jurisdictions over interest income of the States of source and residence and defines the terms necessary to apply Article XI. As with other benefits of the Convention, the benefits of Article XI are available to a resident of a Contracting State only if that resident is entitled to those benefits under the provisions of Article XXIX A (Limitation on Benefits).

Paragraph 1 of Article XI

New paragraph 1 generally grants to the residence State the exclusive right to tax interest beneficially owned by its residents and arising in the other Contracting State. See the Technical Explanation for new paragraphs 6 and 7 of Article IV (Residence) for discussion regarding the interaction between domestic law concepts of beneficial ownership and the treaty rules to determine when a person is considered to derive an item of income for purposes of obtaining benefits under the Convention such as withholding rate reductions.

Subparagraph 3(d) of Article 27 of the Protocol provides an additional rule regarding the application of paragraph 1 during the first two years that end after the Protocol's entry into force. This rule is described in detail in the Technical Explanation to Article 27.

Paragraph 2 of Article XI

Paragraph 2 of new Article XI is substantially identical to paragraph 4 of Article XI of the existing Convention.

Paragraph 2 defines the term "interest" as used in Article XI to include, *inter alia*, income from debt claims of every kind, whether or not secured by a mortgage. Interest that is paid or accrued subject to a contingency is within the ambit of Article XI. This includes income from a debt obligation carrying the right to participate in profits. The term does not, however, include amounts that are treated as dividends under Article X (Dividends).

The term "interest" also includes amounts subject to the same tax treatment as income from money lent under the law of the State in which the income arises. Thus, for purposes of the Convention, amounts that the United States will treat as interest include (i) the difference between the issue price and the stated redemption price at maturity of a debt instrument (*i.e.*, original issue discount (OID)), which may be wholly or partially realized on the disposition of a debt instrument (section 1273), (ii) amounts that are imputed interest on a deferred sales contract (section 483), (iii) amounts treated as interest or OID under the stripped bond rules (section 1286), (iv) amounts treated as original issue discount under the below-market interest rate rules (section 7872), (v) a partner's distributive share of a partnership's interest income (section 702), (vi) the interest portion of periodic payments made under a "finance lease" or similar contractual arrangement that in substance is a borrowing by the nominal lessee to finance the acquisition of property, (vii) amounts included in the income of a holder of a residual interest in a real estate mortgage investment conduit (REMIC) (section 860E), because these amounts generally are subject to the same taxation treatment as interest under U.S. tax law, and (viii) interest with respect to notional principal contracts that are re-characterized as loans because of a "substantial non-periodic payment."

Paragraph 3 of Article XI

Paragraph 3 is in all material respects the same as paragraph 5 of Article XI of the existing Convention. New paragraph 3 adds clarifying language consistent with the changes made in Articles 4, 5, and 7 of the Protocol with respect to income attributable to a permanent establishment that has ceased to exist. Also, consistent with the changes described in Article 9 of the Protocol, discussed below, paragraph 3 does not contain references to the performance of independent personal services through a fixed base.

Paragraph 3 provides an exception to the exclusive residence taxation rule of paragraph 1 in cases where the beneficial owner of the interest carries on business through a permanent establishment in the State of source and the interest is effectively connected to that permanent establishment. In such cases the provisions of Article VII (Business Profits) will apply and the source State will retain the right to impose tax on such interest income.

Paragraph 4 of Article XI

Paragraph 4 is in all material respects the same as paragraph 6 of Article XI of the existing Convention. The only difference is that, consistent with the changes described below with respect to Article 9 of the Protocol, paragraph 4 does not contain references to a fixed base.

Paragraph 4 establishes the source of interest for purposes of Article XI. Interest is considered to arise in a Contracting State if the payer is that State, or a political subdivision, local authority, or resident of that State. However, in cases where the person paying the interest, whether a resident of a Contracting State or of a third State, has in a State other than that of which he is a resident a permanent establishment in connection with which the indebtedness on which the interest was paid was incurred, and such interest is borne by the permanent establishment, then such interest is deemed to arise in the State in which the permanent establishment is situated and not in the State of the payer's residence. Furthermore, pursuant to paragraphs 1 and 4, and Article XXII (Other Income), Canadian tax will not be imposed on interest paid to a U.S. resident by a company resident in Canada if the indebtedness is incurred in connection with, and the interest is borne by, a permanent establishment of the company situated in a third State. For the purposes of this Article, "borne by" means allowable as a deduction in computing taxable income.

Paragraph 5 of Article XI

Paragraph 5 is identical to paragraph 7 of Article XI of the existing Convention.

Paragraph 5 provides that in cases involving special relationships between the payer and the beneficial owner of interest income or between both of them and some other person, Article XI applies only to that portion of the total 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 Canada, respectively, with due regard to the other provisions of the Convention.

Paragraph 6 of Article XI

New paragraph 6 provides anti-abuse exceptions to exclusive residence State taxation in paragraph 1 for two classes of interest payments.

The first class of interest, dealt with in subparagraphs 6(a) and 6(b), is so-called "contingent interest." With respect to interest arising in the United States, subparagraph 6(a) refers to contingent interest of a type that does not qualify as portfolio interest under U.S. domestic law. The cross-reference to the U.S. definition of contingent interest, which is found in Code section 871(h)(4), is intended to ensure that the exceptions of Code section 871(h)(4)(C) will apply. With respect to Canada, such interest is defined in subparagraph 6(b) as any interest arising in Canada that is determined by reference to the receipts, sales, income, profits or other cash flow of the debtor or a related person, to any change in the value of any property of the debtor or a related person or to any dividend, partnership distribution or similar payment made by the debtor or a related person.[1] Any such interest may be taxed in Canada according to the laws of Canada.

Under subparagraph 6(a) or 6(b), if the beneficial owner is a resident of the other Contracting State, the gross amount of the "contingent interest" may be taxed at a rate not exceeding 15 percent.

The second class of interest is dealt with in subparagraph 6(c). This exception is consistent with the policy of Code sections 860E(e) and 860G(b) that excess inclusions with respect to a real estate mortgage investment conduit (REMIC) should bear full U.S. tax in all cases. Without a full tax at source, foreign purchasers of residual interests would have a competitive advantage over U.S. purchasers at the time these interests are initially offered. Also, absent this rule, the U.S. fisc would suffer a revenue loss with respect to mortgages held in a REMIC because of opportunities for tax avoidance created by differences in the timing of taxable and economic income produced by these interests.

Therefore, subparagraph 6(c) provides a bilateral provision that interest that is an excess inclusion with respect to a residual interest in a REMIC may be taxed by each State in accordance with its domestic law. While the provision is written reciprocally, at the time the Protocol was signed, the provision had no application in respect of Canadian-source interest, as Canada did not have REMICs.

Paragraph 7 of Article XI

Paragraph 7 is in all material respects the same as paragraph 8 of Article XI of the existing Convention. The only difference is that, consistent with the changes made in Article 9 of the Protocol, paragraph 7 removes the references to a fixed base.

Paragraph 7 restricts the right of a Contracting State to impose tax on interest paid by a resident of the other Contracting State. The first State may not impose any tax on such interest except insofar as the interest is paid to a resident of that State or arises in that State or the debt claim in respect of which the interest is paid is effectively connected with a permanent establishment situated in that State.

[1] New subparagraph 6(b) of Article XI erroneously refers to a "similar payment made by the debtor to a related person." The correct formulation, which the Contracting States agree to apply, is "similar payment made by the debtor or a related person."

Relationship to other Articles

Notwithstanding the foregoing limitations on source State taxation of interest, the saving clause of paragraph 2 of Article XXIX (Miscellaneous Rules) permits the United States to tax its residents and citizens, subject to the special foreign tax credit rules of paragraph 5 of Article XXIV (Elimination of Double Taxation), as if the Convention had not come into force.

Article 7

Article 7 of the Protocol amends Article XII (Royalties) of the existing Convention. As with other benefits of the Convention, the benefits of Article XII are available to a resident of a Contracting State only if that resident is entitled to those benefits under the provisions of Article XXIX A (Limitation on Benefits).

See the Technical Explanation for new paragraphs 6 and 7 of Article IV (Residence) for discussion regarding the interaction between domestic law concepts of beneficial ownership and the treaty rules to determine when a person is considered to derive an item of income for purposes of obtaining benefits of the Convention such as withholding rate reductions.

Paragraph 1

Paragraph 1 of Article 7 of the Protocol replaces paragraph 5 of Article XII of the Convention. In all material respects, new paragraph 5 is the same as paragraph 5 of Article XII of the existing Convention. However, new paragraph 5 adds clarifying language consistent with the changes made in Articles 4, 5, and 6 of the Protocol with respect to income attributable to a permanent establishment that has ceased to exist. To conform with Article 9 of the Protocol, which deletes Article XIV (Independent Personal Services) of the Convention, paragraph 1 of Article 7 of the Protocol also amends paragraph 5 of Article XII by omitting the reference to a "fixed base."

New paragraph 5 provides that the 10 percent limitation on tax in the source State provided by paragraph 2, and the exemption in the source State for certain royalties provided by paragraph 3, do not apply if the beneficial owner of the royalties carries on or has carried on business in the source State through a permanent establishment and the right or property in respect of which the royalties are paid is attributable to such permanent establishment. In such case, the royalty income would be taxable by the source State under the provisions of Article VII (Business Profits).

Paragraph 2

Paragraph 2 of Article 7 of the Protocol sets forth a new subparagraph 6(a) of Article XII that is in all material respects the same as subparagraph 6(a) of Article XII of the existing Convention. The only difference is that, consistent with the changes made in Article 9 of the Protocol, new subparagraph 6(a) omits references to a "fixed base."

Paragraph 3

Paragraph 3 of Article 7 of Protocol amends paragraph 8 of Article XII of the Convention to remove references to a "fixed base." In addition, paragraph 8 of the General Note confirms the intent of the Contracting States that the reference in subparagraph 3(c) of Article XII of the Convention to information provided in connection with a franchise agreement generally refers only to information that governs or otherwise

deals with the operation (whether by the payer or by another person) of the franchise, and not to other information concerning industrial, commercial or scientific experience that is held for resale or license.

Article 8

Paragraph 1

Paragraph 1 of Article 8 of the Protocol replaces paragraph 2 of Article XIII (Gains) of the existing Convention. Consistent with Article 9 of the Protocol, new paragraph 2 does not contain any reference to property pertaining to a fixed base or to the performance of independent personal services.

New paragraph 2 of Article XIII provides that the Contracting State in which a resident of the other Contracting State has or had a permanent establishment may tax gains from the alienation of personal property constituting business property if such gains are attributable to such permanent establishment. Unlike paragraph 1 of Article VII (Business Profits), paragraph 2 limits the right of the source State to tax such gains to a twelve-month period following the termination of the permanent establishment.

Paragraph 2

Paragraph 2 of Article 8 of the Protocol replaces paragraph 5 of Article XIII of the existing Convention. In general, new paragraph 5 provides an exception to the general rule stated in paragraph 4 that gains from the alienation of any property, other than property referred to in paragraphs 1, 2, and 3, shall be taxable only in the Contracting State of which the alienator is a resident. Paragraph 5 provides that a Contracting State may, according to its domestic law, impose tax on gains derived by an individual who is a resident of the other Contracting State if such individual was a resident of the first-mentioned State for 120 months (whether or not consecutive) during any period of 20 consecutive years preceding the alienation of the property, and was a resident of that State at any time during the 10-year period immediately preceding the alienation of the property. Further, the property (or property received in substitution in a tax-free transaction in the first-mentioned State) must have been owned by the individual at the time he ceased to be a resident of the first-mentioned State and must not have been property that the individual was treated as having alienated by reason of ceasing to be a resident of the first-mentioned State and becoming a resident of the other Contracting State.

The provisions of new paragraph 5 are substantially similar to paragraph 5 of Article XIII of the existing Convention. However, the Protocol adds a new requirement to paragraph 5 that the property not be "a property that the individual was treated as having alienated by reason of ceasing to be a resident of the first-mentioned State and becoming a resident of the other Contracting State." This new requirement reflects the fact that the main purpose of paragraph 5 – ensuring that gains that accrue while an individual is resident in a Contracting State remain taxable for the stated time after the individual has moved to the other State – is met if that pre-departure gain is taxed in the first State immediately before the individual's emigration. This rule applies whether or not the individual makes the election provided by paragraph 7 of Article XIII, as amended, which is described below.

Paragraph 3

Paragraph 3 of Article 8 of the Protocol replaces paragraph 7 of Article XIII.

The purpose of paragraph 7, in both its former and revised form, is to provide a rule to coordinate U.S. and Canadian taxation of gains in the case of a timing mismatch. Such a mismatch may occur, for example, where a Canadian resident is deemed, for Canadian tax purposes, to recognize capital gain upon emigrating from Canada to the United States, or in the case of a gift that Canada deems to be an income producing event for its tax purposes but with respect to which the United States defers taxation while assigning the donor's basis to the donee. The former paragraph 7 resolved the timing mismatch of taxable events by allowing the individual to elect to be liable to tax in the deferring Contracting State as if he had sold and repurchased the property for an amount equal to its fair market value at a time immediately prior to the deemed alienation.

The election under former paragraph 7 was not available to certain non-U.S. citizens subject to tax in Canada by virtue of a deemed alienation because such individuals could not elect to be liable to tax in the United States. To address this problem, the Protocol replaces the election provided in former paragraph 7, with an election by the taxpayer to be treated by a Contracting State as having sold and repurchased the property for its fair market value immediately before the taxable event in the other Contracting State. The election in new paragraph 7 therefore will be available to any individual who emigrates from Canada to the United States, without regard to whether the person is a U.S. citizen immediately before ceasing to be a resident of Canada. If the individual is not subject to U.S. tax at that time, the effect of the election will be to give the individual an adjusted basis for U.S. tax purposes equal to the fair market value of the property as of the date of the deemed alienation in Canada, with the result that only post-emigration gain will be subject to U.S. tax when there is an actual alienation. If the Canadian resident is also a U.S. citizen at the time of his emigration from Canada, then the provisions of new paragraph 7 would allow the U.S. citizen to accelerate the tax under U.S. tax law and allow tax credits to be used to avoid double taxation. This would also be the case if the person, while not a U.S. citizen, would otherwise be subject to taxation in the United States on a disposition of the property.

In the case of Canadian taxation of appreciated property given as a gift, absent paragraph 7, the donor could be subject to tax in Canada upon making the gift, and the donee may be subject to tax in the United States upon a later disposition of the property on all or a portion of the same gain in the property without the availability of any foreign tax credit for the tax paid to Canada. Under new paragraph 7, the election will be available to any individual who pays taxes in Canada on a gain arising from the individual's gifting of a property, without regard to whether the person is a U.S. taxpayer at the time of the gift. The effect of the election in such case will be to give the donee an adjusted basis for U.S. tax purposes equal to the fair market value as of the date of the gift. If the donor is a U.S. taxpayer, the effect of the election will be the realization of gain or loss for U.S. purposes immediately before the gift. The acceleration of the U.S. tax liability by reason of the election in such case enables the donor to utilize foreign tax credits and avoid double taxation with respect to the disposition of the property.

Generally, the rule does not apply in the case of death. Note, however, that Article XXIX B (Taxes Imposed by Reason of Death) of the Convention provides rules that coordinate the income tax that Canada imposes by reason of death with the U.S. estate tax.

If in one Contracting State there are losses and gains from deemed alienations of different properties, then paragraph 7 must be applied consistently in the other Contracting State within the taxable period with respect to all such properties. Paragraph 7 only applies, however, if the deemed alienations of the properties result in a net gain.

Taxpayers may make the election provided by new paragraph 7 only with respect to property that is subject to a Contracting State's deemed disposition rules and with respect to which gain on a deemed alienation is recognized for that Contracting State's tax purposes in the taxable year of the deemed alienation. At the time the Protocol was signed, the following were the main types of property that were excluded from the deemed disposition rules in the case of individuals (including trusts) who cease to be residents of Canada: real property situated in Canada; interests and rights in respect of pensions; life insurance policies (other than segregated fund (investment) policies); rights in respect of annuities; interests in testamentary trusts, unless acquired for consideration; employee stock options; property used in a business carried on through a permanent establishment in Canada (including intangibles and inventory); interests in most Canadian personal trusts; Canadian resource property; and timber resource property.

Paragraph 4

Consistent with the provisions of Article 9 of the Protocol, paragraph 4 of Article 8 of the Protocol amends subparagraph 9(c) of Article XIII of the existing Convention to remove the words "or pertained to a fixed base."

Relationship to other Articles

The changes to Article XIII set forth in paragraph 3 were announced in a press release issued by the Treasury Department on September 18, 2000. Consistent with that press release, subparagraph 3(e) of Article 27 of the Protocol provides that the changes, jointly effectuated by paragraphs 2 and 3, will be generally effective for alienations of property that occur after September 17, 2000.

Article 9

To conform with the current U.S. and OECD Model Conventions, Article 9 of the Protocol deletes Article XIV (Independent Personal Services) of the Convention. The subsequent articles of the Convention are not renumbered. Paragraph 4 of the General Note elaborates that current tax treaty practice omits separate articles for independent personal services because a determination of the existence of a fixed base is qualitatively the same as the determination of the existence of a permanent establishment. Accordingly, the taxation of income from independent personal services is adequately governed by the provisions of Articles V (Permanent Establishment) and VII (Business Profits).

Article 10

Article 10 of the Protocol renames Article XV of the Convention as "Income from Employment" to conform with the current U.S. and OECD Model Conventions, and replaces paragraphs 1 and 2 of that renamed article consistent with the OECD Model Convention.

Paragraph 1

New paragraph 1 of Article XV provides that, in general, salaries, wages, and other remuneration derived by a resident of a Contracting State in respect of an employment are taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is exercised in the other Contracting State, the

entire remuneration derived therefrom may be taxed in that other State, subject to the provisions of paragraph 2.

New paragraph 1 of Article XV does not contain a reference to "similar" remuneration. This change was intended to clarify that Article XV applies to any form of compensation for employment, including payments in kind. This interpretation is consistent with paragraph 2.1 of the Commentary to Article 15 (Income from Employment) of the OECD Model and the Technical Explanation of the 2006 U.S. Model.

Paragraph 2

New paragraph 2 of Article XV provides two limitations on the right of a source State to tax remuneration for services rendered in that State. New paragraph 2 is divided into two subparagraphs that each sets forth a rule which, notwithstanding any contrary result due to the application of paragraph 1 of Article XV, prevents the source State from taxing income from employment in that State.

First, subparagraph 2(a) provides a safe harbor rule that the remuneration may not be taxed in the source State if such remuneration is $10,000 or less in the currency of the source State. This rule is identical to the rule in subparagraph 2(a) of Article XV of the existing Convention. It is understood that, consistent with the prior rule, the safe harbor will apply on a calendar-year basis.

Second, if the remuneration is not exempt from tax in the source State by virtue of subparagraph 2(a), subparagraph 2(b) provides an additional rule that the source State may not tax remuneration for services rendered in that State if the recipient is present in the source State for a period (or periods) that does not exceed in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned, and the remuneration is not paid by or on behalf of a person who is a resident of that other State or borne by a permanent establishment in that other State. For purposes of this article, "borne by" means allowable as a deduction in computing taxable income.

Assume, for example, that Mr. X, an individual resident in Canada, is an employee of the Canadian permanent establishment of USCo, a U.S. company. Mr. X is sent to the United States to perform services and is present in the United States for less than 183 days. Mr. X receives more than $10,000 (U.S.) in the calendar year(s) in question. The remuneration paid to Mr. X for such services is not exempt from U.S. tax under paragraph 1, because his employer, USCo, is a resident of the United States and pays his remuneration. If instead Mr. X received less than $10,000 (U.S.), such earnings would be exempt from tax in the United States, because in all cases where an employee earns less than $10,000 in the currency of the source State, such earnings are exempt from tax in the source State.

As another example, assume Ms. Y, an individual resident in the United States is employed by USCo, a U.S. company. Ms. Y is sent to Canada to provide services in the Canadian permanent establishment of USCo. Ms. Y is present in Canada for less than 183 days. Ms. Y receives more than $10,000 (Canadian) in the calendar year(s) in question. USCo charges the Canadian permanent establishment for Ms. Y's remuneration, which the permanent establishment takes as a deduction in computing its taxable income. The remuneration paid to Ms. Y for such services is not exempt from Canadian tax under paragraph 1, because her remuneration is borne by the Canadian permanent establishment.

New subparagraph 2(b) refers to remuneration that is paid by or on behalf of a "person" who is a resident of the other Contracting State, as opposed to an "employer." This change is intended only to clarify that both the United States and Canada understand that in certain abusive cases, substance over form principles may be applied to recharacterize an employment relationship, as prescribed in paragraph 8 of the Commentary to Article 15 (Income from Employment) of the OECD Model. Subparagraph 2(b) is intended to have the same meaning as the analogous provisions in the U.S. and OECD Models.

Paragraph 6 of the General Note

Paragraph 6 of the General Note contains special rules regarding employee stock options. There are no similar rules in the U.S. Model or the OECD Model, although the issue is discussed in detail in paragraph 12 of the Commentary to Article 15 (Income from Employment) of the OECD Model.

The General Note sets forth principles that apply for purposes of applying Article XV and Article XXIV (Elimination of Double Taxation) to income of an individual in connection with the exercise or other disposal (including a deemed exercise or disposal) of an option that was granted to the individual as an employee of a corporation or mutual fund trust to acquire shares or units ("securities") of the employer in respect of services rendered or to be rendered by such individual, or in connection with the disposal (including a deemed disposal) of a security acquired under such an option. For this purpose, the term "employer" is considered to include any entity related to the service recipient. The reference to a disposal (or deemed disposal) reflects the fact that under Canadian law and under certain provisions of U.S. law, income or gain attributable to the granting or exercising of the option may, in some cases, not be recognized until disposition of the securities.

Subparagraph 6(a) of the General Note provides a specific rule to address situations where, under the domestic law of the Contracting States, an employee would be taxable by both Contracting States in respect of the income in connection with the exercise or disposal of the option. The rule provides an allocation of taxing rights where (1) an employee has been granted a stock option in the course of employment in one of the Contracting States, and (2) his principal place of employment has been situated in one or both of the Contracting States during the period between grant and exercise (or disposal) of the option. In this situation, each Contracting State may tax as Contracting State of source only that proportion of the income that relates to the period or periods between the grant and the exercise (or disposal) of the option during which the individual's principal place of employment was situated in that Contracting State. The proportion attributable to a Contracting State is determined by multiplying the income by a fraction, the numerator of which is the number of days between the grant and exercise (or disposal) of the option during which the employee's principal place of employment was situated in that Contracting State and the denominator of which is the total number of days between grant and exercise (or disposal) of the option that the employee was employed by the employer.

If the individual is a resident of one of the Contracting States at the time he exercises the option, that Contracting State will have the right, as the State of residence, to tax all of the income under the first sentence of paragraph 1 of Article XV. However, to the extent that the employee renders his employment in the other Contracting State for some period of time between the date of the grant of the option and the date of the exercise (or disposal) of the option, the proportion of the income that is allocated to the other Contracting State under subparagraph 6(a) of the General Note will, subject to

paragraph 2, be taxable by that other State under the second sentence of paragraph 1 of Article XV of the Convention. For this purpose, the tests of paragraph 2 of Article XV are applied to the year or years in which the relevant services were performed in the other Contracting State (and not to the year in which the option is exercised or disposed). To the extent the same income is subject to taxation in both Contracting States after application of Article XV, double taxation will be alleviated under the rules of Article XXIV (Elimination of Double Taxation).

Subparagraph 6(b) of the General Note provides that notwithstanding subparagraph 6(a), if the competent authorities of both Contracting States agree that the terms of the option were such that the grant of the option is appropriately treated as transfer of ownership of the securities (*e.g.*, because the options were in-the-money or not subject to a substantial vesting period), then they may agree to attribute income accordingly.

Article 11

Consistent with Article 9 and paragraph 1 of Article 10 of the Protocol, paragraphs 1, 2, and 3 of Article 11 of the Protocol revise paragraphs 1, 2, and 4 of Article XVI (Artistes and Athletes) of the existing Convention by deleting references to former Article XIV (Independent Personal Services) of the Convention and deleting and replacing other language in acknowledgement of the renaming of Article XV (Income from Employment).

Article 12

Article 12 of the Protocol deletes Article XVII (Withholding of Taxes in Respect of Personal Services) from the Convention. However, the subsequent Articles are not renumbered.

Article 13

Article 13 of the Protocol replaces paragraphs 3, 4, and 7 and adds paragraphs 8 through 17 to Article XVIII (Pensions and Annuities) of the Convention.

Paragraph 1

Roth IRAs

Paragraph 1 of Article 13 of the Protocol separates the provisions of paragraph 3 of Article XVIII into two subparagraphs. Subparagraph 3(a) contains the existing definition of the term "pensions," while subparagraph 3(b) adds a new rule to address the treatment of Roth IRAs or similar plan (as described below).

Subparagraph 3(a) of Article XVIII provides that the term "pensions" for purposes of the Convention includes any payment under a superannuation, pension, or other retirement arrangement, Armed-Forces retirement pay, war veterans pensions and allowances, and amounts paid under a sickness, accident, or disability plan, but does not include payments under an income-averaging annuity contract (which are subject to Article XXII (Other Income)) or social security benefits, including social security benefits in respect of government services (which are subject to paragraph 5 of Article XVIII). Thus, the term "pensions" includes pensions paid by private employers (including pre-tax and Roth 401(k) arrangements) as well as any pension paid in respect

of government services. Further, the definition of "pensions" includes, for example, payments from individual retirement accounts (IRAs) in the United States and from registered retirement savings plans (RRSPs) and registered retirement income funds (RRIFs) in Canada.

Subparagraph 3(b) of Article XVIII provides that the term "pensions" generally includes a Roth IRA, within the meaning of Code section 408A (or a similar plan described below). Consequently, under paragraph 1 of Article XVIII, distributions from a Roth IRA to a resident of Canada generally continue to be exempt from Canadian tax to the extent they would have been exempt from U.S. tax if paid to a resident of the United States. In addition, residents of Canada generally may make an election under paragraph 7 of Article XVIII to defer any taxation in Canada with respect to income accrued in a Roth IRA but not distributed by the Roth IRA, until such time as and to the extent that a distribution is made from the Roth IRA or any plan substituted therefore. Because distributions will be exempt from Canadian tax to the extent they would have been exempt from U.S. tax if paid to a resident of the United States, the effect of these rules is that, in most cases, no portion of the Roth IRA will be subject to taxation in Canada.

However, subparagraph 3(b) also provides that if an individual who is a resident of Canada makes contributions to his or her Roth IRA while a resident of Canada, other than rollover contributions from another Roth IRA (or a similar plan described below), the Roth IRA will cease to be considered a pension at that time with respect to contributions and accretions from such time and accretions from such time will be subject to tax in Canada in the year of accrual. Thus, the Roth IRA will in effect be bifurcated into a "frozen" pension that continues to be subject to the rules of Article XVIII and a savings account that is not subject to the rules of Article XVIII. It is understood by the Contracting States that, following a rollover contribution from a Roth 401(k) arrangement to a Roth IRA, the Roth IRA will continue to be treated as a pension subject to the rules of Article XVIII.

Assume, for example, that Mr. X moves to Canada on July 1, 2008. Mr. X has a Roth IRA with a balance of 1,100 on July 1, 2008. Mr. X elects under paragraph 7 of Article XVIII to defer any taxation in Canada with respect to income accrued in his Roth IRA while he is a resident of Canada. Mr. X makes no additional contributions to his Roth IRA until July 1, 2010, when he makes an after-tax contribution of 100. There are accretions of 20 during the period July 1, 2008 through June 30, 2010, which are not taxed in Canada by reason of the election under paragraph 7 of Article XVIII. There are additional accretions of 50 during the period July 1, 2010 through June 30, 2015, which are subject to tax in Canada in the year of accrual. On July 1, 2015, while Mr. X is still a resident of Canada, Mr. X receives a lump-sum distribution of 1,270 from his Roth IRA. The 1,120 that was in the Roth IRA on June 30, 2010 is treated as a distribution from a pension plan that, pursuant to paragraph 1 of Article XVIII, is exempt from tax in Canada provided it would be exempt from tax in the United States under the Internal Revenue Code if paid to a resident of the United States. The remaining 150 comprises the after-tax contribution of 100 in 2010 and accretions of 50 that were subject to Canadian tax in the year of accrual.

The rules of new subparagraph 3(b) of Article XVIII also will apply to any plan or arrangement created pursuant to legislation enacted by either Contracting State after September 21, 2007 (the date of signature of the Protocol) that the competent authorities agree is similar to a Roth IRA.

Source of payments under life insurance and annuity contracts

Paragraph 1 of Article 13 also replaces paragraph 4 of Article XVIII. Subparagraph 4(a) contains the existing definition of annuity, while subparagraph 4(b) adds a source rule to address the treatment of certain payments by branches of insurance companies.

Subparagraph 4(a) provides that, for purposes of the Convention, the term "annuity" means a stated sum paid periodically at stated times during life or during a specified number of years, under an obligation to make the payments in return for adequate and full consideration other than services rendered. The term does not include a payment that is not periodic or any annuity the cost of which was deductible for tax purposes in the Contracting State where the annuity was acquired. Items excluded from the definition of "annuity" and not dealt with under another Article of the Convention are subject to the rules of Article XXII (Other Income).

Under the existing Convention, payments under life insurance and annuity contracts to a resident of Canada by a Canadian branch of a U.S. insurance company are subject to either a 15-percent withholding tax under subparagraph 2(b) of Article XVIII or, unless dealt with under another Article of the Convention, an unreduced 30-percent withholding tax under paragraph 1 of Article XXII, depending on whether the payments constitute annuities within the meaning of paragraph 4 of Article XVIII.

On July 12, 2004, the Internal Revenue Service issued Revenue Ruling 2004-75, 2004-2 C.B. 109, which provides in relevant part that annuity payments under, and withdrawals of cash value from, life insurance or annuity contracts issued by a foreign branch of a U.S. life insurance company are U.S.-source income that, when paid to a nonresident alien individual, is generally subject to a 30-percent withholding tax under Code sections 871(a) and 1441. Revenue Ruling 2004-97, 2004-2 C.B. 516, provided that Revenue Ruling 2004-75 would not be applied to payments that were made before January 1, 2005, provided that such payments were made pursuant to binding life insurance or annuity contracts issued on or before July 12, 2004.

Under new subparagraph 4(b) of Article XVIII, an annuity or other amount paid in respect of a life insurance or annuity contract (including a withdrawal in respect of the cash value thereof), will generally be deemed to arise in the Contracting State where the person paying the annuity or other amount (the "payer") is resident. However, if the payer, whether a resident of a Contracting State or not, has a permanent establishment in a Contracting State other than a Contracting State in which the payer is a resident, the payment will be deemed to arise in the Contracting State in which the permanent establishment is situated if both of the following requirements are satisfied: (i) the obligation giving rise to the annuity or other amount must have been incurred in connection with the permanent establishment, and (ii) the annuity or other amount must be borne by the permanent establishment. When these requirements are satisfied, payments by a Canadian branch of a U.S. insurance company will be deemed to arise in Canada.

Paragraph 2

Paragraph 2 of Article 13 of the Protocol replaces paragraph 7 of Article XVIII of the existing Convention. Paragraph 7 continues to provide a rule with respect to the taxation of a natural person on income accrued in a pension or employee benefit plan in the other Contracting State. Thus, paragraph 7 applies where an individual is a citizen or resident of a Contracting State and is a beneficiary of a trust, company, organization, or

other arrangement that is a resident of the other Contracting State, where such trust, company, organization, or other arrangement is generally exempt from income taxation in that other State, and is operated exclusively to provide pension, or employee benefits. In such cases, the beneficiary may elect to defer taxation in his State of residence on income accrued in the plan until it is distributed from the plan (or from another plan in that other Contracting State to which the income is transferred pursuant to the domestic law of that other Contracting State).

Paragraph 2 of Article 13 of the Protocol makes two changes to paragraph 7 of Article XVIII of the existing Convention. The first change is that the phrase "pension, retirement or employee benefits" is changed to "pension or employee benefits" solely to reflect the fact that in certain cases, discussed above, Roth IRAs will not be treated as pensions for purposes of Article XVIII. The second change is that "under" is changed to "subject to" to make it clear that an election to defer taxation with respect to undistributed income accrued in a plan may be made whether or not the competent authority of the first-mentioned State has prescribed rules for making an election. For the U.S. rules, see Revenue Procedure 2002-23, 2002-1 C.B. 744. As of the date the Protocol was signed, the competent authority of Canada had not prescribed rules.

Paragraph 3

Paragraph 3 of Article 13 of the Protocol adds paragraphs 8 through 17 to Article XVIII to deal with cross-border pension contributions. These paragraphs are intended to remove barriers to the flow of personal services between the Contracting States that could otherwise result from discontinuities in the laws of the Contracting States regarding the deductibility of pension contributions. Such discontinuities may arise where a country allows deductions or exclusions to its residents for contributions, made by them or on their behalf, to resident pension plans, but does not allow deductions or exclusions for payments made to plans resident in another country, even if the structure and legal requirements of such plans in the two countries are similar.

There is no comparable set of rules in the OECD Model, although the issue is discussed in detail in the Commentary to Article 18 (Pensions). The 2006 U.S. Model deals with this issue in paragraphs 2 through 4 of Article 18 (Pension Funds).

Workers on short-term assignments in the other Contracting State

Paragraphs 8 and 9 of Article XVIII address the case of a short-term assignment where an individual who is participating in a "qualifying retirement plan" (as defined in paragraph 15 of Article XVIII) in one Contracting State (the "home State") performs services as an employee for a limited period of time in the other Contracting State (the "host State"). If certain requirements are satisfied, contributions made to, or benefits accrued under, the plan by or on behalf of the individual will be deductible or excludible in computing the individual's income in the host State. In addition, contributions made to the plan by the individual's employer will be allowed as a deduction in computing the employer's profits in the host State.

In order for paragraph 8 to apply, the remuneration that the individual receives with respect to the services performed in the host State must be taxable in the host State. This means, for example, that where the United States is the host State, paragraph 8 would not apply if the remuneration that the individual receives with respect to the services performed in the United States is exempt from taxation in the United States under Code section 893.

The individual also must have been participating in the plan, or in another similar plan for which the plan was substituted, immediately before he began performing services in the host State. The rule regarding a successor plan would apply if, for example, the employer has been acquired by another corporation that replaces the existing plan with its own plan, transferring membership in the old plan over into the new plan.

In addition, the individual must not have been a resident (as determined under Article IV (Residence)) of the host State immediately before he began performing services in the host State. It is irrelevant for purposes of paragraph 8 whether the individual becomes a resident of the host State while he performs services there. A citizen of the United States who has been a resident of Canada may be entitled to benefits under paragraph 8 if (a) he performs services in the United States for a limited period of time and (b) he was a resident of Canada immediately before he began performing such services.

Benefits are available under paragraph 8 only for so long as the individual has not performed services in the host State for the same employer (or a related employer) for more than 60 of the 120 months preceding the individual's current taxable year. The purpose of this rule is to limit the period of time for which the host State will be required to provide benefits for contributions to a plan from which it is unlikely to be able to tax the distributions. If the individual continues to perform services in the host State beyond this time limit, he is expected to become a participant in a plan in the host State. Canada's domestic law provides preferential tax treatment for employer contributions to foreign pension plans in respect of services rendered in Canada by short-term residents, but such treatment ceases once the individual has been resident in Canada for at least 60 of the preceding 72 months.

The contributions and benefits must be attributable to services performed by the individual in the host State, and must be made or accrued during the period in which the individual performs those services. This rule prevents individuals who render services in the host State for a very short period of time from making disproportionately large contributions to home State plans in order to offset the tax liability associated with the income earned in the host State. In the case where the United States is the host State, contributions will be deemed to have been made on the last day of the preceding taxable year if the payment is on account of such taxable year and is treated under U.S. law as a contribution made on the last day of the preceding taxable year.

If an individual receives benefits in the host State with respect to contributions to a plan in the home State, the services to which the contributions relate may not be taken into account for purposes of determining the individual's entitlement to benefits under any trust, company, organization, or other arrangement that is a resident of the host State, generally exempt from income taxation in that State and operated to provide pension or retirement benefits. The purpose of this rule is to prevent double benefits for contributions to both a home State plan and a host State plan with respect to the same services. Thus, for example, an individual who is working temporarily in the United States and making contributions to a qualifying retirement plan in Canada with respect to services performed in the United States may not make contributions to an individual retirement account (within the meaning of Code section 408(a)) in the United States with respect to the same services.

Paragraph 8 states that it applies only to the extent that the contributions or benefits would qualify for tax relief in the home State if the individual were a resident of and performed services in that State. Thus, benefits would be limited in the same fashion

as if the individual continued to be a resident of the home State. However, paragraph 9 provides that if the host State is the United States and the individual is a citizen of the United States, the benefits granted to the individual under paragraph 8 may not exceed the benefits that would be allowed by the United States to its residents for contributions to, or benefits otherwise accrued under, a generally corresponding pension or retirement plan established in and recognized for tax purposes by the United States. Thus, the lower of the two limits applies. This rule ensures that U.S. citizens working temporarily in the United States and participating in a Canadian plan will not get more favorable U.S. tax treatment than U.S. citizens participating in a U.S. plan.

Where the United States is the home State, the amount of contributions that may be excluded from the employee's income under paragraph 8 for Canadian purposes is limited to the U.S. dollar amount specified in Code section 415 or the U.S. dollar amount specified in Code section 402(g)(1) to the extent contributions are made from the employee's compensation. For this purpose, the dollar limit specified in Code section 402(g)(1) means the amount applicable under Code section 402(g)(1) (including the age 50 catch-up amount in Code section 402(g)(1)(C)) or, if applicable, the parallel dollar limit applicable under Code section 457(e)(15) plus the age 50 catch-up amount under Code section 414(v)(2)(B)(i) for a Code section 457(g) trust.

Where Canada is the home State, the amount of contributions that may be excluded from the employee's income under paragraph 8 for U.S. purposes is subject to the limitations specified in subsections 146(5), 147(8), 147.1(8) and (9) and 147.2(1) and (4) of the Income Tax Act and paragraph 8503(4)(a) of the Income Tax Regulations, as applicable. If the employee is a citizen of the United States, then the amount of contributions that may be excluded is the lesser of the amounts determined under the limitations specified in the previous sentence and the amounts specified in the previous paragraph.

The provisions described above provide benefits to employees. Paragraph 8 also provides that contributions made to the home State plan by an individual's employer will be allowed as a deduction in computing the employer's profits in the host State, even though such a deduction might not be allowable under the domestic law of the host State. This rule applies whether the employer is a resident of the host State or a permanent establishment that the employer has in the host State. The rule also applies to contributions by a person related to the individual's employer, such as contributions by a parent corporation for its subsidiary, that are treated under the law of the host State as contributions by the individual's employer. For example, if an individual who is participating in a qualifying retirement plan in Canada performs services for a limited period of time in the United States for a U.S. subsidiary of a Canadian company, a contribution to the Canadian plan by the parent company in Canada that is treated under U.S. law as a contribution by the U.S. subsidiary would be covered by the rule.

The amount of the allowable deduction is to be determined under the laws of the home State. Thus, where the United States is the home State, the amount of the deduction that is allowable in Canada will be subject to the limitations of Code section 404 (including the Code section 401(a)(17) and 415 limitations). Where Canada is the home State, the amount of the deduction that is allowable in the United States is subject to the limitations specified in subsections 147(8), 147.1(8) and (9) and 147.2(1) of the Income Tax Act, as applicable.

Cross-border commuters

Paragraphs 10, 11, and 12 of Article XVIII address the case of a commuter who is a resident of one Contracting State (the "residence State") and performs services as an employee in the other Contracting State (the "services State") and is a member of a "qualifying retirement plan" (as defined in paragraph 15 of Article XVIII) in the services State. If certain requirements are satisfied, contributions made to, or benefits accrued under, the qualifying retirement plan by or on behalf of the individual will be deductible or excludible in computing the individual's income in the residence State.

In order for paragraph 10 to apply, the individual must perform services as an employee in the services State the remuneration from which is taxable in the services State and is borne by either an employer who is a resident of the services State or by a permanent establishment that the employer has in the services State. The contributions and benefits must be attributable to those services and must be made or accrued during the period in which the individual performs those services. In the case where the United States is the residence State, contributions will be deemed to have been made on the last day of the preceding taxable year if the payment is on account of such taxable year and is treated under U.S. law as a contribution made on the last day of the preceding taxable year.

Paragraph 10 states that it applies only to the extent that the contributions or benefits qualify for tax relief in the services State. Thus, the benefits granted in the residence State are available only to the extent that the contributions or benefits accrued qualify for relief in the services State. Where the United States is the services State, the amount of contributions that may be excluded under paragraph 10 is the U.S. dollar amount specified in Code section 415 or the U.S. dollar amount specified in Code section 402(g)(1) (as defined above) to the extent contributions are made from the employee's compensation. Where Canada is the services State, the amount of contributions that may be excluded from the employee's income under paragraph 10 is subject to the limitations specified in subsections 146(5), 147(8), 147.1(8) and (9) and 147.2(1) and (4) of the Income Tax Act and paragraph 8503(4)(a) of the Income Tax Regulations, as applicable.

However, paragraphs 11 and 12 further provide that the benefits granted under paragraph 10 by the residence State may not exceed certain benefits that would be allowable under the domestic law of the residence State.

Paragraph 11 provides that where Canada is the residence State, the amount of contributions otherwise allowable as a deduction under paragraph 10 may not exceed the individual's deduction limit for contributions to registered retirement savings plans (RRSPs) remaining after taking into account the amount of contributions to RRSPs deducted by the individual under the law of Canada for the year. The amount deducted by the individual under paragraph 10 will be taken into account in computing the individual's deduction limit for subsequent taxation years for contributions to RRSPs. This rule prevents double benefits for contributions to both an RRSP and a qualifying retirement plan in the United States with respect to the same services.

Paragraph 12 provides that if the United States is the residence State, the benefits granted to an individual under paragraph 10 may not exceed the benefits that would be allowed by the United States to its residents for contributions to, or benefits otherwise accrued under, a generally corresponding pension or retirement plan established in and recognized for tax purposes by the United States. For purposes of determining an individual's eligibility to participate in and receive tax benefits with respect to a pension or retirement plan or other retirement arrangement in the United States, contributions

made to, or benefits accrued under, a qualifying retirement plan in Canada by or on behalf of the individual are treated as contributions or benefits under a generally corresponding pension or retirement plan established in and recognized for tax purposes by the United States. Thus, for example, the qualifying retirement plan in Canada would be taken into account for purposes of determining whether the individual is an "active participant" within the meaning of Code section 219(g)(5), with the result that the individual's ability to make deductible contributions to an individual retirement account in the United States would be limited.

Paragraph 10 does not address employer deductions because the employer is located in the services State and is already eligible for deductions under the domestic law of the services State.

U.S. citizens resident in Canada

Paragraphs 13 and 14 of Article XVIII address the special case of a U.S. citizen who is a resident of Canada (as determined under Article IV (Residence)) and who performs services as an employee in Canada and participates in a qualifying retirement plan (as defined in paragraph 15 of Article XVIII) in Canada. If certain requirements are satisfied, contributions made to, or benefits accrued under, a qualifying retirement plan in Canada by or on behalf of the U.S. citizen will be deductible or excludible in computing his or her taxable income in the United States. These provisions are generally consistent with paragraph 4 of Article 18 of the U.S. Model treaty.

In order for paragraph 13 to apply, the U.S. citizen must perform services as an employee in Canada the remuneration from which is taxable in Canada and is borne by an employer who is a resident of Canada or by a permanent establishment that the employer has in Canada. The contributions and benefits must be attributable to those services and must be made or accrued during the period in which the U.S. citizen performs those services. Contributions will be deemed to have been made on the last day of the preceding taxable year if the payment is on account of such taxable year and is treated under U.S. law as a contribution made on the last day of the preceding taxable year.

Paragraph 13 states that it applies only to the extent the contributions or benefits qualify for tax relief in Canada. However, paragraph 14 provides that the benefits granted under paragraph 13 may not exceed the benefits that would be allowed by the United States to its residents for contributions to, or benefits otherwise accrued under, a generally corresponding pension or retirement plan established in and recognized for tax purposes by the United States. Thus, the lower of the two limits applies. This rule ensures that a U.S. citizen living and working in Canada does not receive better U.S. treatment than a U.S. citizen living and working in the United States. The amount of contributions that may be excluded from the employee's income under paragraph 13 is the U.S. dollar amount specified in Code section 415 or the U.S. dollar amount specified in Code section 402(g)(1) (as defined above) to the extent contributions are made from the employee's compensation. In addition, pursuant to Code section 911(d)(6), an individual may not claim benefits under paragraph 13 with respect to services the remuneration for which is excluded from the individual's gross income under Code section 911(a).

For purposes of determining the individual's eligibility to participate in and receive tax benefits with respect to a pension or retirement plan or other retirement arrangement established in and recognized for tax purposes by the United States, contributions made to, or benefits accrued under, a qualifying retirement plan in Canada

by or on behalf of the individual are treated as contributions or benefits under a generally corresponding pension or retirement plan established in and recognized for tax purposes by the United States. Thus, for example, the qualifying retirement plan in Canada would be taken into account for purposes of determining whether the individual is an "active participant" within the meaning of Code section 219(g)(5), with the result that the individual's ability to make deductible contributions to an individual retirement account in the United States would be limited.

Paragraph 13 does not address employer deductions because the employer is located in Canada and is already eligible for deductions under the domestic law of Canada.

Definition of "qualifying retirement plan"

Paragraph 15 of Article XVIII provides that for purposes of paragraphs 8 through 14, a "qualifying retirement plan" in a Contracting State is a trust, company, organization, or other arrangement that (a) is a resident of that State, generally exempt from income taxation in that State and operated primarily to provide pension or retirement benefits; (b) is not an individual arrangement in respect of which the individual's employer has no involvement; and (c) the competent authority of the other Contracting State agrees generally corresponds to a pension or retirement plan established in and recognized for tax purposes in that State. Thus, U.S. individual retirement accounts (IRAs) and Canadian registered retirement savings plans (RRSPs) are not treated as qualifying retirement plans unless addressed in paragraph 10 of the General Note (as discussed below). In addition, a Canadian retirement compensation arrangement (RCA) is not a qualifying retirement plan because it is not considered to be generally exempt from income taxation in Canada.

Paragraph 10 of the General Note provides that the types of Canadian plans that constitute qualifying retirement plans for purposes of paragraph 15 include the following and any identical or substantially similar plan that is established pursuant to legislation introduced after the date of signature of the Protocol (September 21, 2007): registered pension plans under section 147.1 of the Income Tax Act, registered retirement savings plans under section 146 that are part of a group arrangement described in subsection 204.2(1.32), deferred profit sharing plans under section 147, and any registered retirement savings plan under section 146, or registered retirement income fund under section 146.3, that is funded exclusively by rollover contributions from one or more of the preceding plans.

Paragraph 10 of the General Note also provides that the types of U.S. plans that constitute qualifying retirement plans for purposes of paragraph 15 include the following and any identical or substantially similar plan that is established pursuant to legislation introduced after the date of signature of the Protocol (September 21, 2007): qualified plans under Code section 401(a) (including Code section 401(k) arrangements), individual retirement plans that are part of a simplified employee pension plan that satisfies Code section 408(k), Code section 408(p) simple retirement accounts, Code section 403(a) qualified annuity plans, Code section 403(b) plans, Code section 457(g) trusts providing benefits under Code section 457(b) plans, the Thrift Savings Fund (Code section 7701(j)), and any individual retirement account under Code section 408(a) that is funded exclusively by rollover contributions from one or more of the preceding plans.

If a particular plan in one Contracting State is of a type specified in paragraph 10 of the General Note with respect to paragraph 15 of Article XVIII, it will not be necessary for taxpayers to obtain a determination from the competent authority of the

other Contracting State that the plan generally corresponds to a pension or retirement plan established in and recognized for tax purposes in that State. A taxpayer who believes a particular plan in one Contracting State that is not described in paragraph 10 of the General Note nevertheless satisfies the requirements of paragraph 15 may request a determination from the competent authority of the other Contracting State that the plan generally corresponds to a pension or retirement plan established in and recognized for tax purposes in that State. In the case of the United States, such a determination must be requested under Revenue Procedure 2006-54, 2006-49 I.R.B. 655 (or any applicable analogous provision). In the case of Canada, the current version of Information Circular 71-17 provides guidance on obtaining assistance from the Canadian competent authority.

Source rule

Paragraph 16 of Article XVIII provides that a distribution from a pension or retirement plan that is reasonably attributable to a contribution or benefit for which a benefit was allowed pursuant to paragraph 8, 10, or 13 of Article XVIII will be deemed to arise in the Contracting State in which the plan is established. This ensures that the Contracting State in which the plan is established will have the right to tax the gross amount of the distribution under subparagraph 2(a) of Article XVIII, even if a portion of the services to which the distribution relates were not performed in such Contracting State.

Partnerships

Paragraph 17 of Article XVIII provides that paragraphs 8 through 16 of Article XVIII apply, with such modifications as the circumstances require, as though the relationship between a partnership that carries on a business, and an individual who is a member of the partnership, were that of employer and employee. This rule is needed because paragraphs 8, 10, and 13, by their terms, apply only with respect to contributions made to, or benefits accrued under, qualifying retirement plans by or on behalf of individuals who perform services as an employee. Thus, benefits are not available with respect to retirement plans for self-employed individuals, who may be deemed under U.S. law to be employees for certain pension purposes. Paragraph 17 ensures that partners participating in a plan established by their partnership may be eligible for the benefits provided by paragraphs 8, 10, and 13.

Relationship to other Articles

Paragraphs 8, 10, and 13 of Article XVIII are not subject to the saving clause of paragraph 2 of Article XXIX (Miscellaneous Rules) by reason of the exception in subparagraph 3(a) of Article XXIX.

Article 14

Consistent with Articles 9 and 10 of the Protocol, Article 14 of the Protocol amends Article XIX (Government Service) of the Convention by deleting the reference to "Article XIV (Independent Personal Services)" and replacing such reference with the reference to "Article VII (Business Profits)" and by reflecting the new name of Article XV (Income from Employment).

Article 15

Article 15 of the Protocol replaces Article XX (Students) of the Convention. Article XX provides rules for host-country taxation of visiting students and business

trainees. Persons who meet the tests of Article XX will be exempt from tax in the State that they are visiting with respect to designated classes of income. Several conditions must be satisfied in order for an individual to be entitled to the benefits of this Article.

First, the visitor must have been, either at the time of his arrival in the host State or immediately before, a resident of the other Contracting State.

Second, the purpose of the visit must be the full-time education or training of the visitor. Thus, if the visitor comes principally to work in the host State but also is a part-time student, he would not be entitled to the benefits of this Article, even with respect to any payments he may receive from abroad for his maintenance or education, and regardless of whether or not he is in a degree program. Whether a student is to be considered full-time will be determined by the rules of the educational institution at which he is studying.

The host State exemption in Article XX applies to payments received by the student or business trainee for the purpose of his maintenance, education or training that arise outside the host State. A payment will be considered to arise outside the host State if the payer is located outside the host State. Thus, if an employer from one of the Contracting States sends an employee to the other Contracting State for full-time training, the payments the trainee receives from abroad from his employer for his maintenance or training while he is present in the host State will be exempt from tax in the host State. Where appropriate, substance prevails over form in determining the identity of the payer. Thus, for example, payments made directly or indirectly by a U.S. person with whom the visitor is training, but which have been routed through a source outside the United States (*e.g.*, a foreign subsidiary), are not treated as arising outside the United States for this purpose.

In the case of an apprentice or business trainee, the benefits of Article XX will extend only for a period of one year from the time that the individual first arrives in the host country for the purpose of the individual's training. If, however, an apprentice or trainee remains in the host country for a second year, thus losing the benefits of the Article, he would not retroactively lose the benefits of the Article for the first year.

Relationship to other Articles

The saving clause of paragraph 2 of Article XXIX (Miscellaneous Rules) does not apply to Article XX with respect to an individual who neither is a citizen of the host State nor has been admitted for permanent residence there. The saving clause, however, does apply with respect to citizens and permanent residents of the host State. Thus, a U.S. citizen who is a resident of Canada and who visits the United States as a full-time student at an accredited university will not be exempt from U.S. tax on remittances from abroad that otherwise constitute U.S. taxable income. However, an individual who is not a U.S. citizen, and who visits the United States as a student and remains long enough to become a resident under U.S. law, but does not become a permanent resident (*i.e.*, does not acquire a green card), will be entitled to the full benefits of the Article.

Article 16

Article 16 of the Protocol revises Article XXI (Exempt Organizations) of the existing Convention.

Paragraph 1

Paragraph 1 amends Article XXI by renumbering paragraphs 4, 5, and 6 as 5, 6, and 7, respectively.

Paragraph 2

Paragraph 2 replaces paragraphs 1 through 3 of Article XXI with four new paragraphs. In general, the provisions of former paragraphs 1 through 3 have been retained.

New paragraph 1 provides that a religious, scientific, literary, educational, or charitable organization resident in a Contracting State shall be exempt from tax on income arising in the other Contracting State but only to the extent that such income is exempt from taxation in the Contracting State in which the organization is resident.

New paragraph 2 retains the provisions of former subparagraph 2(a), and provides that a trust, company, organization, or other arrangement that is resident in a Contracting State and operated exclusively to administer or provide pension, retirement or employee benefits or benefits for the self-employed under one or more funds or plans established to provide pension or retirement benefits or other employee benefits is exempt from taxation on dividend and interest income arising in the other Contracting State in a taxable year, if the income of such organization or other arrangement is generally exempt from taxation for that year in the Contracting State in which it is resident.

New paragraph 3 replaces and expands the scope of former subparagraph 2(b) Former subparagraph 2(b) provided that, subject to the provisions of paragraph 3 (new paragraph 4), a trust, company, organization or other arrangement that was a resident of a Contracting State, generally exempt from income taxation in that State and operated exclusively to earn income for the benefit of one or more organizations described in subparagraph 2(a) (new paragraph 2) was exempt from taxation on dividend and interest income arising in the other Contracting State in a taxable year. The Internal Revenue Service concluded in private letter rulings (PLR 200111027 and PLR 200111037) that a pooled investment fund that included as investors one or more organizations described in paragraph 1 could not qualify for benefits under former subparagraph 2(b). New paragraph 3 now allows organizations described in paragraph 1 to invest in pooled funds with trusts, companies, organizations, or other arrangements described in new paragraph 2.

Former subparagraph 2(b) did not exempt income earned by a trust, company or other arrangement for the benefit of religious, scientific, literary, educational or charitable organizations exempt from tax under paragraph 1. Therefore, the Protocol expands the scope of paragraph 3 to include such income.

As noted above with respect to Article X (Dividends), paragraph 3 of the General Note explains that distributions from Canadian income trusts and royalty trusts that are treated as dividends as a result of changes to Canada's law regarding taxation of income and royalty trusts shall be treated as dividends for the purposes of Article X. Accordingly, such distributions will also be entitled to the benefits of Article XXI.

New paragraph 4 replaces paragraph 3 and provides that the exemptions provided by paragraphs 1, 2, 3 do not apply with respect to the income of a trust, company, organization or other arrangement from carrying on a trade or business or from a related

person, other than a person referred to in paragraph 1, 2 or 3. The term "related person" is not necessarily defined by paragraph 2 of Article IX (Related Person).

Article 17

Article 17 of the Protocol amends Article XXII (Other Income) of the Convention by adding a new paragraph 4. Article XXII generally assigns taxing jurisdiction over income not dealt with in the other articles (Articles VI through XXI) of the Convention.

New paragraph 4 provides a specific rule for residence State taxation of compensation derived in respect of a guarantee of indebtedness. New paragraph 4 provides that compensation derived by a resident of a Contracting State in respect of the provision of a guarantee of indebtedness shall be taxable only in that State, unless the compensation is business profits attributable to a permanent establishment situated in the other Contracting State, in which case the provisions of Article VII (Business Profits) shall apply. The clarification that Article VII shall apply when the compensation is considered business profits was included at the request of the United States. Compensation paid to a financial services entity to provide a guarantee in the ordinary course of its business of providing such guarantees to customers constitutes business profits dealt with under the provisions of Article VII. However, provision of guarantees with respect to debt of related parties is ordinarily not an independent economic undertaking that would generate business profits, and thus compensation in respect of such related-party guarantees is, in most cases, covered by Article XXII.

Article 18

Article 18 of the Protocol amends paragraph 2 of Article XXIII (Capital) of the Convention by deleting language contained in that paragraph consistent with the changes made by Article 9 of the Protocol.

Article 19

Article 19 of the Protocol deletes subparagraph 2(b) of Article XXIV (Elimination of Double Taxation) of the Convention and replaces it with a new subparagraph.

New subparagraph 2(b) allows a Canadian company receiving a dividend from a U.S. resident company of which it owns at least 10 percent of the voting stock, a credit against Canadian income tax of the appropriate amount of income tax paid or accrued to the United States by the dividend paying company with respect to the profits out of which the dividends are paid. The third Protocol to the Convention, signed March 17, 1995, had amended subparagraph (b) to allow a Canadian company to deduct in computing its Canadian taxable income any dividend received by it out of the exempt surplus of a foreign affiliate which is a resident of the United States. This change is consistent with current Canadian tax treaty practice: it does not indicate any present intention to change Canada's "exempt surplus" rules, and those rules remain in effect.

Article 20

Article 20 of the Protocol revises Article XXV (Non-Discrimination) of the existing Convention to bring that Article into closer conformity to U.S. tax treaty policy.

Paragraphs 1 and 2

Paragraph 1 replaces paragraph 1 of Article XXV of the existing Convention. New paragraph 1 provides that a national of one Contracting State may not be subject to taxation or connected requirements in the other Contracting State that are more burdensome than the taxes and connected requirements imposed upon a national of that other State in the same circumstances. The OECD Model would prohibit taxation that is "other than or more burdensome" than that imposed on U.S. persons. Paragraph 1 omits the words "other than or" because the only relevant question under this provision should be whether the requirement imposed on a national of the other Contracting State is more burdensome. A requirement may be different from the requirements imposed on U.S. nationals without being more burdensome.

The term "national" in relation to a Contracting State is defined in subparagraph 1(k) of Article III (General Definitions). The term includes both individuals and juridical persons. 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 Canada as a national of Canada in the same or similar circumstances (*i.e.*, one who is resident in a third State).

Whether or not the two persons are both taxable on worldwide income is a significant circumstance for this purpose. For this reason, paragraph 1 specifically refers to taxation or any requirement connected therewith, particularly with respect to taxation on worldwide income, as relevant circumstances. This language means that the United States is not obliged to apply the same taxing regime to a national of Canada who is not resident in the United States as it applies to a U.S. national who is not resident in the United States. U.S. citizens who are not resident in the United States but who are, nevertheless, subject to U.S. tax on their worldwide income are not in the same circumstances with respect to U.S. taxation as citizens of Canada who are not U.S. residents. Thus, for example, Article XXV would not entitle a national of Canada residing in a third country to taxation at graduated rates on U.S.-source dividends or other investment income that applies to a U.S. citizen residing in the same third country.

Because of the increased coverage of paragraph 1 with respect to the treatment of nationals wherever they are resident, paragraph 2 of this Article no longer has application, and therefore has been omitted.

Paragraph 3

Paragraph 3 makes changes to renumbered paragraph 3 of Article XXV in order to conform with Article 10 of the Protocol by deleting the reference to "Article XV (Dependent Personal Services)" and replacing it with a reference to "Article XV (Income from Employment)."

Article 21

Paragraph 1 of Article 21 of the Protocol replaces paragraph 6 of Article XXVI (Mutual Agreement Procedure) of the Convention with new paragraphs 6 and 7. New paragraphs 6 and 7 provide a mandatory binding arbitration proceeding (Arbitration Proceeding). The Arbitration Note details additional rules and procedures that apply to a case considered under the arbitration provisions.

New paragraph 6 provides that a case shall be resolved through arbitration when the competent authorities have endeavored but are unable through negotiation to reach a complete agreement regarding a case and the following three conditions are satisfied. First, tax returns have been filed with at least one of the Contracting States with respect to the taxable years at issue in the case. Second, the case (i) involves the application of one or more Articles that the competent authorities have agreed in an exchange of notes shall be the subject of arbitration and is not a case that the competent authorities agree before the date on which an Arbitration Proceeding would otherwise have begun, is not suitable for determination by arbitration; or (ii) is a case that the competent authorities agree is suitable for determination by arbitration. Third, all concerned persons and their authorized representatives agree, according to the provisions of subparagraph 7(d), not to disclose to any other person any information received during the course of the Arbitration Proceeding from either Contracting State or the arbitration board, other than the determination of the board (confidentiality agreement). The confidentiality agreement may also be executed by any concerned person that has the legal authority to bind any other concerned person on the matter. For example, a parent corporation with the legal authority to bind its subsidiary with respect to confidentiality may execute a comprehensive confidentiality agreement on its own behalf and that of its subsidiary.

The United States and Canada have agreed in the Arbitration Note to submit cases regarding the application of one or more of the following Articles to mandatory binding arbitration under the provisions of paragraphs 6 and 7 of Article XXVI: IV (Residence), but only insofar as it relates to the residence of a natural person, V (Permanent Establishment), VII (Business Profits), IX (Related Persons), and XII (Royalties) (but only (i) insofar as Article XII might apply in transactions involving related persons to whom Article IX might apply, or (ii) to an allocation of amounts between royalties that are taxable under paragraph 2 thereof and royalties that are exempt under paragraph 3 thereof). The competent authorities may, however, agree, before the date on which an Arbitration Proceeding would otherwise have begun, that a particular case is not suitable for arbitration.

New paragraph 7 provides six subparagraphs that detail the general rules and definitions to be used in applying the arbitration provisions.

Subparagraph 7(a) provides that the term "concerned person" means the person that brought the case to competent authority for consideration under Article XXVI (Mutual Agreement Procedure) and includes all other persons, if any, whose tax liability to either Contracting State may be directly affected by a mutual agreement arising from that consideration. For example, a concerned person does not only include a U.S. corporation that brings a transfer pricing case with respect to a transaction entered into with its Canadian subsidiary for resolution to the U.S. competent authority, but also the Canadian subsidiary, which may have a correlative adjustment as a result of the resolution of the case.

Subparagraph 7(c) provides that an Arbitration Proceeding begins on the later of two dates: two years from the "commencement date" of the case (unless the competent authorities have previously agreed to a different date), or the earliest date upon which all concerned persons have entered into a confidentiality agreement and the agreements have been received by both competent authorities. The "commencement date" of the case is defined by subparagraph 7(b) as the earliest date the information necessary to undertake substantive consideration for a mutual agreement has been received by both competent authorities.

Paragraph 16 of the Arbitration Note provides that each competent authority will confirm in writing to the other competent authority and to the concerned persons the date of its receipt of the information necessary to undertake substantive consideration for a mutual agreement. In the case of the United States, this information is (i) the information that must be submitted to the U.S. competent authority under Section 4.05 of Rev. Proc. 2006-54, 2006-49 I.R.B. 1035 (or any applicable successor publication), and (ii) for cases initially submitted as a request for an Advance Pricing Agreement, the information that must be submitted to the Internal Revenue Service under Rev. Proc. 2006-9, 2006-2 I.R.B. 278 (or any applicable successor publication). In the case of Canada, this information is the information required to be submitted to the Canadian competent authority under Information Circular 71-17 (or any applicable successor publication). The information shall not be considered received until both competent authorities have received copies of all materials submitted to either Contracting State by the concerned person(s) in connection with the mutual agreement procedure. It is understood that confirmation of the "information necessary to undertake substantive consideration for a mutual agreement" is envisioned to ordinarily occur within 30 days after the necessary information is provided to the competent authority.

The Arbitration Note also provides for several procedural rules once an Arbitration Proceeding under paragraph 6 of Article XXVI ("Proceeding") has commenced, but the competent authorities may modify or supplement these rules as necessary. In addition, the arbitration board may adopt any procedures necessary for the conduct of its business, provided the procedures are not inconsistent with any provision of Article XXVI of the Convention.

Paragraph 5 of the Arbitration Note provides that each Contracting State has 60 days from the date on which the Arbitration Proceeding begins to send a written communication to the other Contracting State appointing one member of the arbitration board. Within 60 days of the date the second of such communications is sent, these two board members will appoint a third member to serve as the chair of the board. It is agreed that this third member ordinarily should not be a citizen of either of the Contracting States.

In the event that any members of the board are not appointed (including as a result of the failure of the two members appointed by the Contracting States to agree on a third member) by the requisite date, the remaining members are appointed by the highest ranking member of the Secretariat at the Centre for Tax Policy and Administration of the Organisation for Economic Co-operation and Development (OECD) who is not a citizen of either Contracting State, by written notice to both Contracting States within 60 days of the date of such failure.

Paragraph 7 of the Arbitration Note establishes deadlines for submission of materials by the Contracting States to the arbitration board. Each competent authority has 60 days from the date of appointment of the chair to submit a Proposed Resolution describing the proposed disposition of the specific monetary amounts of income, expense or taxation at issue in the case, and a supporting Position Paper. Copies of each State's submissions are to be provided by the board to the other Contracting State on the date the later of the submissions is submitted to the board. Each of the Contracting States may submit a Reply Submission to the board within 120 days of the appointment of the chair to address points raised in the other State's Proposed Resolution or Position Paper. If one Contracting State fails to submit a Proposed Resolution within the requisite time, the Proposed Resolution of the other Contracting State is deemed to be the determination of the arbitration board. Additional information may be supplied to the arbitration board by a Contracting State only at the request of the arbitration board. The board will provide

copies of any such requested information, along with the board's request, to the other Contracting State on the date the request is made or the response is received.

All communication with the board is to be in writing between the chair of the board and the designated competent authorities with the exception of communication regarding logistical matters.

In making its determination, the arbitration board will apply the following authorities as necessary: (i) the provisions of the Convention, (ii) any agreed commentaries or explanation of the Contracting States concerning the Convention as amended, (iii) the laws of the Contracting States to the extent they are not inconsistent with each other, and (iv) any OECD Commentary, Guidelines or Reports regarding relevant analogous portions of the OECD Model Tax Convention.

The arbitration board must deliver a determination in writing to the Contracting States within six months of the appointment of the chair. The determination must be one of the two Proposed Resolutions submitted by the Contracting States. The determination shall provide a determination regarding only the amount of income, expense or tax reportable to the Contracting States. The determination has no precedential value and consequently the rationale behind a board's determination would not be beneficial and shall not be provided by the board.

Paragraph 11 of the Arbitration Note provides that, unless any concerned person does not accept the decision of the arbitration board, the determination of the board constitutes a resolution by mutual agreement under Article XXVI and, consequently, is binding on both Contracting States. Each concerned person must, within 30 days of receiving the determination from the competent authority to which the case was first presented, advise that competent authority whether the person accepts the determination. The failure to advise the competent authority within the requisite time is considered a rejection of the determination. If a determination is rejected, the case cannot be the subject of a subsequent MAP procedure on the same issue(s) determined by the panel, including a subsequent Arbitration Proceeding. After the commencement of an Arbitration Proceeding but before a decision of the board has been accepted by all concerned persons, the competent authorities may reach a mutual agreement to resolve the case and terminate the Proceeding.

For purposes of the Arbitration Proceeding, the members of the arbitration board and their staffs shall be considered "persons or authorities" to whom information may be disclosed under Article XXVII (Exchange of Information). The Arbitration Note provides that all materials prepared in the course of, or relating to, the Arbitration Proceeding are considered information exchanged between the Contracting States. No information relating to the Arbitration Proceeding or the board's determination may be disclosed by members of the arbitration board or their staffs or by either competent authority, except as permitted by the Convention and the domestic laws of the Contracting States. Members of the arbitration board and their staffs must agree in statements sent to each of the Contracting States in confirmation of their appointment to the arbitration board to abide by and be subject to the confidentiality and nondisclosure provisions of Article XXVII of the Convention and the applicable domestic laws of the Contracting States, with the most restrictive of the provisions applying.

The applicable domestic law of the Contracting States determines the treatment of any interest or penalties associated with a competent authority agreement achieved through arbitration.

In general, fees and expenses are borne equally by the Contracting States, including the cost of translation services. However, meeting facilities, related resources, financial management, other logistical support, and general and administrative coordination of the Arbitration Proceeding will be provided, at its own cost, by the Contracting State that initiated the Mutual Agreement Procedure. The fees and expenses of members of the board will be set in accordance with the International Centre for Settlement of Investment Disputes (ICSID) Schedule of Fees for arbitrators (in effect on the date on which the arbitration board proceedings begin). All other costs are to be borne by the Contracting State that incurs them. Since arbitration of MAP cases is intended to assist taxpayers in resolving a governmental difference of opinion regarding the taxation of their income, and is merely an extension of the competent authority process, no fees will be chargeable to a taxpayer in connection with arbitration.

Article 22

Article 22 of the Protocol amends Article XXVI A (Assistance in Collection) of the existing Convention. Article XXVI A sets forth provisions under which the United States and Canada have agreed to assist each other in the collection of taxes.

Paragraph 1

Paragraph 1 replaces subparagraph 8(a) of Article XXVI A. In general, new subparagraph 8(a) provides the circumstances under which no assistance is to be given under the Article for a claim in respect of an individual taxpayer. New subparagraph 8(a) contains language that is in substance the same as subparagraph 8(a) of Article XXVI A of the existing Convention. However, the revised subparagraph also provides that no assistance in collection is to be given for a revenue claim from a taxable period that ended before November 9, 1995 in respect of an individual taxpayer, if the taxpayer became a citizen of the requested State at any time before November 9, 1995 and is such a citizen at the time the applicant State applies for collection of the claim.

The additional language is intended to avoid the potentially discriminating application of former subparagraph 8(a) as applied to persons who were not citizens of the requested State in the taxable period to which a particular collection request related, but who became citizens of the requested State at a time prior to the entry into force of Article XXVI A as set forth in the third protocol signed March 17, 1995. New subparagraph 8(a) addresses this situation by treating the citizenship of a person in the requested State at anytime prior to November 9, 1995 as comparable to citizenship in the requested State during the period for which the claim for assistance relates if 1) the person is a citizen of the requested state at the time of the request for assistance in collection, and 2) the request relates to a taxable period ending prior to November 9, 1995. As is provided in subparagraph 3(g) of Article 27, this change will have effect for revenue claims finally determined after November 9, 1985, the effective date of the adoption of collection assistance in the third protocol signed March 17, 1995.

Paragraph 2

Paragraph 2 replaces paragraph 9 of Article XXVI A of the Convention. Under paragraph 1 of Article XXVI A, each Contracting State generally agrees 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. New 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, and to contributions to social security and employment insurance premiums levied, by or on

behalf of the Government of a Contracting State. Prior to the Protocol, paragraph 9 did not contain a specific reference to contributions to social security and employment insurance premiums. Although the prior language covered U.S. federal social security and unemployment taxes, the language did not cover Canada's social security (*e.g.*, Canada Pension Plan) and employment insurance programs, contributions to which are not considered taxes under Canadian law and therefore would not otherwise have come within the scope of the paragraph.

Article 23

Article 23 of the Protocol replaces Article XXVII (Exchange of Information) of the Convention.

Paragraph 1 of Article XXVII

New paragraph 1 of Article XXVII is substantially the same as paragraph 1 of Article XXVII of the existing Convention. Paragraph 1 authorizes the competent authorities to exchange information as may be relevant for carrying out the provisions of the Convention or the domestic laws of Canada and the United States concerning taxes covered by the Convention, insofar as the taxation under those domestic laws is not contrary to the Convention. New paragraph 1 changes the phrase "is relevant" to "may be relevant" to clarify that the language incorporates the standard in Code section 7602 which authorizes the Internal Revenue Service to examine "any books, papers, records, or other data which *may be relevant* or material." (Emphasis added.) In *United States v. Arthur Young & Co.*, 465 U.S. 805, 814 (1984), the Supreme Court stated that "the language 'may be' reflects Congress's express intention to allow the Internal Revenue Service to obtain 'items of even *potential* relevance to an ongoing investigation, without reference to its admissibility.'" (Emphasis in original.) However, the language "may be" would not support a request in which a Contracting State simply asked for information regarding all bank accounts maintained by residents of that Contracting State in the other Contracting State, or even all accounts maintained by its residents with respect to a particular bank.

The authority to exchange information granted by paragraph 1 is not restricted by Article I (Personal Scope), and thus need not relate solely to persons otherwise covered by the Convention. Under paragraph 1, information may be exchanged for use in all phases of the taxation process including assessment, collection, enforcement or the determination of appeals. Thus, the competent authorities may request and provide information for cases under examination or criminal investigation, in collection, on appeals, or under prosecution.

Any information received by a Contracting State pursuant to the Convention is to be treated as secret in the same manner as information obtained under the tax laws of that State. Such information shall be disclosed only to persons or authorities, including courts and administrative bodies, involved in the assessment or collection of, the administration and enforcement in respect of, or the determination of appeals in relation to, the taxes covered by the Convention and the information may be used by such persons only for such purposes. (In accordance with paragraph 4, for the purposes of this Article the Convention applies to a broader range of taxes than those covered specifically by Article II (Taxes Covered)). Although the information received by persons described in paragraph 1 is to be treated as secret, it may be disclosed by such persons in public court proceedings or in judicial decisions.

Paragraph 1 also permits, however, 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). This provision does not authorize a Contracting State to request information on behalf of a state, province, or local authority. Paragraph 1 also authorizes 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.

The provisions of paragraph 1 authorize the U.S. competent authority to continue to allow legislative bodies, such as the tax-writing committees of Congress and the Government Accountability Office to examine tax return information received from Canada when such bodies or offices are engaged in overseeing the administration of U.S. tax laws or a study of the administration of U.S. tax laws pursuant to a directive of Congress. However, the secrecy requirements of paragraph 1 must be met.

It is contemplated that Article XXVII will be utilized by the competent authorities to exchange information upon request, routinely, and spontaneously.

Paragraph 2 of Article XXVII

New paragraph 2 conforms with the corresponding U.S. and OECD Model provisions. The substance of the second sentence of former paragraph 2 is found in new paragraph 6 of the Article, discussed below.

Paragraph 2 provides that if a Contracting State requests information in accordance with Article XXVII, the other Contracting State shall use its information gathering measures to obtain the requested information. The instruction to the requested State to "use its information gathering measures" to obtain the requested information communicates the same instruction to the requested State as the language of former paragraph 2 that stated that the requested State shall obtain the information "in the same way as if its own taxation was involved." Paragraph 2 makes clear that the obligation to provide information is limited by the provisions of paragraph 3, but that such limitations shall not be construed to permit a Contracting State to decline to obtain and supply information because it has no domestic tax interest in such information.

In the absence of such a paragraph, some taxpayers have argued that subparagraph 3(a) prevents a Contracting State from requesting information from a bank or fiduciary that the Contracting State does not need for its own tax purposes. This paragraph clarifies that paragraph 3 does not impose such a restriction and that a Contracting State is not limited to providing only the information that it already has in its own files.

Paragraph 3 of Article XXVII

New paragraph 3 is substantively the same as paragraph 3 of Article XXVII of the existing Convention. Paragraph 3 provides that the provisions of paragraphs 1 and 2 do not impose on Canada or the United States the obligation to carry out administrative measures at variance with the laws and administrative practice of either State; to supply information which is not obtainable under the laws or in the normal course of the administration of either State; or to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy.

Thus, a requesting State may be denied information from the other State if the information would be obtained pursuant to procedures or measures that are broader than those available in the requesting State. However, the statute of limitations of the Contracting State making the request for information should govern a request for information. Thus, the Contracting State of which the request is made should attempt to obtain the information even if its own statute of limitations has passed. In many cases, relevant information will still exist in the business records of the taxpayer or a third party, even though it is no longer required to be kept for domestic tax purposes.

While paragraph 3 states conditions under which a Contracting State is not obligated to comply with a request from the other Contracting State for information, the requested State is not precluded from providing such information, and may, at its discretion, do so subject to the limitations of its internal law.

As discussed with respect to paragraph 2, in no case shall the limitations in paragraph 3 be construed to permit a Contracting State to decline to obtain information and supply information because it has no domestic tax interest in such information.

Paragraph 4 of Article XXVII

The language of new paragraph 4 is substantially similar to former paragraph 4. New paragraph 4, however, consistent with new paragraph 1, discussed above, replaces the words "is relevant" with "may be relevant" in subparagraph 4(b).

Paragraph 4 provides that, for the purposes of Article XXVII, the Convention applies to all taxes imposed by a Contracting State, and to other taxes to which any other provision of the Convention applies, but only to the extent that the information may be relevant for the purposes of the application of that provision.

Article XXVII does not apply to taxes imposed by political subdivisions or local authorities of the Contracting States. Paragraph 4 is designed to ensure that information exchange will extend to taxes of every kind (including, for example, estate, gift, excise, and value added taxes) at the national level in the United States and Canada.

Paragraph 5 of Article XXVII

New paragraph 5 conforms with the corresponding U.S. and OECD Model provisions. Paragraph 5 provides that a Contracting State may not decline to provide information because that information is held by a financial institution, nominee or person acting in an agency or fiduciary capacity. Thus, paragraph 5 would effectively prevent a Contracting State from relying on paragraph 3 to argue that its domestic bank secrecy laws (or similar legislation relating to disclosure of financial information by financial institutions or intermediaries) override its obligation to provide information under paragraph 1. This paragraph also requires the disclosure of information regarding the beneficial owner of an interest in a person.

Paragraph 6 of Article XXVII

The substance of new paragraph 6 is similar to the second sentence of paragraph 2 of Article XXVII of the existing Convention. New paragraph 6 adopts the language of paragraph 6 of Article 26 (Exchange of Information and Administrative Assistance) of the U.S. Model. New paragraph 6 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). The intention is to ensure that the information may be introduced as evidence 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 7 of Article XXVII

New paragraph 7 is consistent with paragraph 8 of Article 26 (Exchange of Information and Administrative Assistance) of the U.S. Model. Paragraph 7 provides that the requested State shall allow representatives of the requesting State to enter the requested State to interview individuals and examine books and records with the consent of the persons subject to examination. Paragraph 7 was intended to reinforce that the administrations can conduct consensual tax examinations abroad, and was not intended to limit travel or supersede any arrangements or procedures the competent authorities may have previously had in place regarding travel for tax administration purposes.

Paragraph 13 of General Note

As is explained in paragraph 13 of the General Note, the United States and Canada understand and agree that the standards and practices described in Article XXVII of the Convention are to be in no respect less effective than those described in the Model Agreement on Exchange of Information on Tax Matters developed by the OECD Global Forum Working Group on Effective Exchange of Information.

Article 24

Article 24 amends Article XXIX (Miscellaneous Rules) of the Convention.

Paragraph 1

Paragraph 1 replaces paragraph 2 of Article XXIX of the existing Convention. New paragraph 2 is divided into two subparagraphs. In general, subparagraph 2(a) provides a "saving clause" pursuant to which the United States and Canada may each tax its residents, as determined under Article IV (Residence), and the United States may tax its citizens and companies, including those electing to be treated as domestic corporations (*e.g.* under Code section 1504(d)), as if there were no convention between the United States and Canada with respect to taxes on income and capital. Subparagraph 2(a) contains language that generally corresponds to former paragraph 2, but omits certain language pertaining to former citizens, which are addressed in new subparagraph 2(b).

New subparagraph 2(b) generally corresponds to the provisions of former paragraph 2 addressing former citizens of the United States. However, new subparagraph 2(b) also includes a reference to former long-term residents of the United States. This addition, as well as other changes in subparagraph 2(b), brings the Convention in conformity with the U.S. taxation of former citizens and long-term residents under Code section 877.

Similar to subparagraph 2(a), new subparagraph 2(b) operates as a "saving clause" and provides that notwithstanding the other provisions of the Convention, a former citizen or former long-term resident of the United States, may, for a period of ten years following the loss of such status, be taxed in accordance with the laws of the United States with respect to income from sources within the United States (including income deemed under the domestic law of the United States to arise from such sources).

Paragraphs 11 and 12 of the General Note provide definitions based on Code section 877 that are relevant to the application of paragraph 2 of Article XXIX. Paragraph 11 of the General Note provides that the term "long-term resident" means any individual who is a lawful permanent resident of the United States in eight or more taxable years during the preceding 15 taxable years. In determining whether the eight-year threshold is met, one does not count any year in which the individual is treated as a resident of Canada under this Convention (or as a resident of any country other than the United States under the provisions of any other U.S. tax treaty), and the individual does not waive the benefits of such treaty applicable to residents of the other country. This understanding is consistent with how this provision is generally interpreted in U.S. tax treaties.

Paragraph 12 of the General Note provides that the phrase "income deemed under the domestic law of the United States to arise from such sources" as used in new subparagraph 2(b) includes gains from the sale or exchange of stock of a U.S. company or debt obligations of a U.S. person, the United States, a State, or a political subdivision thereof, or the District of Columbia, gains from property (other than stock or debt obligations) located in the United States, and, in certain cases, income or gain derived from the sale of stock of a non-U.S. company or a disposition of property contributed to such non-U.S. company where such company would be a controlled foreign corporation with respect to the individual if such person had continued to be a U.S. person. In addition, an individual who exchanges property that gives rise or would give rise to U.S.-source income for property that gives rise to foreign-source income will be treated as if he had sold the property that would give rise to U.S.-source income for its fair market value, and any consequent gain shall be deemed to be income from sources within the United States.

Paragraph 2

Paragraph 2 replaces subparagraph 3(a) of Article XXIX of the existing Convention. Paragraph 3 provides that, notwithstanding paragraph 2 of Article XXIX, the United States and Canada must respect specified provisions of the Convention in regard to certain persons, including residents and citizens. Therefore, subparagraph 3(a) lists certain paragraphs and Articles of the Convention that represent exceptions to the "saving clause" in all situations. New subparagraph 3(a) is substantially similar to former subparagraph 3(a), but now contains a reference to paragraphs 8, 10, and 13 of Article XVIII (Pensions and Annuities) to reflect the changes made to that article in paragraph 3 of Article 13 of the Protocol.

Article 25

Article 25 of the Protocol replaces Article XXIX A (Limitation on Benefits) of the existing Convention, which was added to the Convention by the Protocol done on March 17, 1995. Article XXIX A addresses the problem of "treaty shopping" by residents of third States by requiring, in most cases, that the person seeking benefits not only be a U.S. resident or Canadian resident but also satisfy other tests. For example, 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 or Canada under the Convention to those persons whose residence in the other Contracting State is not considered to have been motivated by the existence of the Convention. As replaced by the Protocol, new Article XXIX A is reciprocal, and many of the changes to the former paragraphs of Article XXIX A are made to effectuate this reciprocal application.

Absent Article XXIX A, an entity resident in one of the Contracting States would be entitled to benefits under the Convention, unless it were denied such benefits as a result of limitations under domestic law (*e.g.*, business purpose, substance-over-form, step transaction, or conduit principles or other anti-avoidance rules) applicable to a particular transaction or arrangement. As noted below in the explanation of paragraph 7, 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 benefits under the Convention, the anti-abuse provisions under U.S. domestic law determine whether a particular transaction should be recast in accordance with the substance of the transaction.

Paragraph 1 of Article XXIX A

New paragraph 1 of Article XXIX A provides that, for the purposes of the application of the Convention, a "qualifying person" shall be entitled to all of the benefits of the Convention and, except as provided in paragraphs 3, 4, and 6, a person that is not a qualifying person shall not be entitled to any benefits of the Convention.

Paragraph 2 of Article XXIX A

New paragraph 2 lists a number of characteristics any one of which will make a United States or Canadian resident a qualifying person. The "look-through" principles introduced by the Protocol (e.g. paragraph 6 of Article IV (Residence)) are to be applied in conjunction with Article XXIX A. Accordingly, the provisions of Article IV shall determine the person who derives an item of income, and the objective tests of Article XXIX A shall be applied to that person to determine whether benefits shall be granted. The rules are essentially mechanical tests and are discussed below.

Individuals and governmental entities

Under new paragraph 2, the first two categories of qualifying persons are (1) natural persons resident in the United States or Canada (as listed in subparagraph 2(a)), and (2) the Contracting States, political subdivisions or local authorities thereof, and any agency or instrumentality of such Government, political subdivision or local authority (as listed in subparagraph 2(b)). Persons falling into these two categories are unlikely to be used, as the beneficial owner of income, to derive benefits under the Convention on behalf of a third-country person. If such a person receives 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 would otherwise 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 new subparagraph 2(c), a company or trust resident in a Contracting State is a qualifying person if the company's principal class of shares, and any disproportionate class of shares, or the trust's units, or disproportionate interest in a trust, are primarily and regularly traded on one or more recognized stock exchanges. The term "recognized stock exchange" is defined in subparagraph 5(f) 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" or "designated stock exchanges" under the Income Tax Act. These are, at the time of signature of the Protocol, the Montreal Stock Exchange, the Toronto Stock Exchange, and Tiers 1 and 2 of the TSX Venture Exchange. 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.

If a company has only one class of shares, it is only necessary to consider whether the shares of that class meet the relevant trading requirements. If the company has more than one class of shares, it is necessary as an initial matter to determine which class or classes constitute the "principal class of shares." The term "principal class of shares" is defined in subparagraph 5(e) of the Article to mean the ordinary or common shares of the company representing the majority of the aggregate voting power and value of the company. If the company does not have a class of ordinary or common shares representing the majority of the aggregate voting power and value of the company, then the "principal class of shares" is that class or any combination of classes of shares that represents, in the aggregate, a majority of the voting power and value of the company. Although in a particular case involving a company with several classes of shares it is conceivable that more than one group of classes could be identified that account for more than 50% of the voting power and value of the shares of the company, it is only necessary for one such group to satisfy the requirements of this subparagraph in order for the company to be entitled to benefits. Benefits would not be denied to the company even if a second, non-qualifying, group of shares with more than half of the company's voting power and value could be identified.

A company whose principal class of shares is regularly traded on a recognized stock exchange will nevertheless not qualify for benefits under subparagraph 2(c) if it has a disproportionate class of shares that is not regularly traded on a recognized stock exchange. The term "disproportionate class of shares" is defined in subparagraph 5(b) of the Article. A company has a disproportionate class of shares if it has outstanding a class of shares which is subject to terms or other arrangements that entitle the holder to a larger portion of the company's income, profit, or gain in the other Contracting State than that to which the holder would be entitled in the absence of such terms or arrangements. Thus, for example, a company has a disproportionate class of shares if it has outstanding a class of "tracking stock" that pays dividends based upon a formula that approximates the company's return on its assets employed in the United States. Similar principles apply to determine whether or not there are disproportionate interests in a trust.

The following example illustrates the application of subparagraph 5(b).

Example. OCo is a corporation resident in Canada. OCo has two classes of shares: Common and Preferred. The Common shares are listed and regularly traded on a designated stock exchange in Canada. The Preferred shares have no voting rights and are entitled to receive dividends equal in amount to interest payments that OCo receives from unrelated borrowers in the United States. The Preferred shares are owned entirely by a single investor that is a resident of a country with which the United States does not have a tax treaty. The Common shares account for more than 50 percent of the value of OCo and for 100 percent of the voting power. Because the owner of the Preferred shares is entitled to receive payments corresponding to the U.S.-source interest income earned by OCo, the Preferred shares are a disproportionate class of shares. Because the Preferred shares are not primarily and regularly traded on a recognized stock exchange, OCo will not qualify for benefits under subparagraph 2(c).

The term "regularly traded" is not defined in the Convention. In accordance with paragraph 2 of Article III (General Definitions) and paragraph 1 of the General Note, this term will be defined by reference to the domestic tax laws of the State from which benefits of the Convention are sought, generally the source State. In the case of the United States, this term is understood to have the meaning it has under Treas. Reg. section 1.884-5(d)(4)(i)(B), relating to the branch tax provisions of the Code, as may be amended from time to time. Under these regulations, a class of shares is considered to be "regularly traded" if two requirements are met: trades in the class of shares are made in more than de minimis quantities on at least 60 days during the taxable year, and the aggregate number of shares in the class traded during the year is at least 10 percent of the average number of shares outstanding during the year. Sections 1.884-5(d)(4)(i)(A), (ii) and (iii) will not be taken into account for purposes of defining the term "regularly traded" under the Convention.

The regularly-traded requirement can be met by trading on one or more recognized stock exchanges. Therefore, trading may be aggregated for purposes of this requirement. Thus, a U.S. company could satisfy the regularly traded requirement through trading, in whole or in part, on a recognized stock exchange located in Canada. Authorized but unissued shares are not considered for purposes of this test.

The term "primarily traded" is not defined in the Convention. In accordance with paragraph 2 of Article III (General Definitions) and paragraph 1 of the General Note, this term will have the meaning it has under the laws of the State concerning the taxes to which the Convention applies, generally the source State. In the case of the United States, this term is understood to have the meaning it has under Treas. Reg. section 1.884-5(d)(3), as may be amended from time to time, relating to the branch tax provisions of the Code. Accordingly, stock of a corporation is "primarily traded" if the number of shares in the company's principal class of shares that are traded during the taxable year on all recognized stock exchanges exceeds the number of shares in the company's principal class of shares that are traded during that year on all other established securities markets.

Subject to the adoption by Canada of other definitions, the U.S. interpretation of "regularly traded" and "primarily traded" will be considered to apply, with such modifications as circumstances require, under the Convention for purposes of Canadian taxation.

Subsidiaries of publicly traded entities

Certain companies owned by publicly traded corporations also may be qualifying persons. Under subparagraph 2(d), a company resident in the United States or Canada will be a qualifying person, even if not publicly traded, if more than 50 percent of the vote and value of its shares, and more than 50 percent of the vote and value of each disproportionate class of shares, is owned (directly or indirectly) by five or fewer persons that are qualifying persons under subparagraph 2(c). In addition, each company in the chain of ownership must be a qualifying person. Thus, for example, a company that is a resident of Canada, all the shares of which are owned by another company that is a resident of Canada, would qualify for benefits of the Convention if the principal class of shares (and any disproportionate classes of shares) of the parent company are regularly and primarily traded on a recognized stock exchange. However, such a subsidiary would not qualify for benefits under subparagraph 2(d) if the publicly traded parent company were a resident of a third state, for example, and not a resident of the United States or Canada. Furthermore, if a parent company qualifying for benefits under subparagraph 2(c) indirectly owned the bottom-tier company through a chain of subsidiaries, each

subsidiary in the chain, as an intermediate owner, must be a qualifying person in order for the bottom-tier subsidiary to meet the test in subparagraph 2(d).

Subparagraph 2(d) provides that a subsidiary can take into account ownership by as many as five companies, each of which qualifies for benefits under subparagraph 2(c) to determine if the subsidiary qualifies for benefits under subparagraph 2(d). 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 primarily and regularly traded on a recognized stock exchange, will qualify under subparagraph 2(d).

By applying the principles introduced by the Protocol (e.g. paragraph 6 of Article IV) in the context of this rule, one "looks through" entities in the chain of ownership that are viewed as fiscally transparent under the domestic laws of the State of residence (other than entities that are resident in the State of source).

The 50-percent test under subparagraph 2(d) applies only to shares other than "debt substitute shares." The term "debt substitute shares" is defined in subparagraph 5(a) to mean shares defined in paragraph (e) of the definition in the Canadian Income Tax Act of "term preferred shares" (see subsection 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. Subparagraph 5(a) also provides that the competent authorities may agree to treat other types of shares as debt substitute shares.

Ownership/base erosion test

Subparagraph 2(e) provides a two-part test under which certain other entities may be qualifying persons, based on ownership and lack of "base erosion." A company resident in the United States or Canada will satisfy the first of these tests if 50 percent or more of the vote and value of its shares and 50 percent or more of the vote and value of each disproportionate class of shares, in both cases not including debt substitute shares, is not owned, directly or indirectly, by persons other than qualifying persons. Similarly, a trust resident in the United States or Canada will satisfy this first test if 50 percent or more of its beneficial interests, and 50 percent or more of each disproportionate interest, is not owned, directly or indirectly, by persons other than qualifying persons. The wording of these tests is intended to make clear that, for example, if a Canadian company is more than 50 percent owned, either directly or indirectly (including cumulative indirect ownership through a chain of entities), by a U.S. resident corporation that is, itself, wholly owned by a third-country resident other than a qualifying person, 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.

It is understood by the Contracting States that in determining whether a company satisfies the ownership test described in subparagraph 2(e)(i), a company, 50 percent of more of the aggregate vote and value of the shares of which and 50 percent or more of the vote and value of each disproportionate class of shares (in neither case including debt substitute shares) of which is owned, directly or indirectly, by a company described in subparagraph 2(c) will satisfy the ownership test of subparagraph 2(e)(i). In such case, no further analysis of the ownership of the company described in subparagraph 2(c) is required. Similarly, in determining whether a trust satisfies the ownership test described in subparagraph 2(e)(ii), a trust, 50 percent or more of the beneficial interest in which and 50 percent or more of each disproportionate interest in which, is owned, directly or indirectly, by a trust described in subparagraph (2)(c) will satisfy the ownership test of

subparagraph (2)(e)(ii), and no further analysis of the ownership of the trust described in subparagraph 2(c) is required.

The second test of subparagraph 2(e) is the so-called "base erosion" test. A company or trust that passes the ownership test must also pass this test to be a qualifying person under this subparagraph. This test requires that the amount of expenses that are paid or payable by the entity in question, directly or indirectly, to persons that are not qualifying persons, and that are deductible from gross income (with both deductibility and gross income as determined under the tax laws of the State of residence of the company or trust), 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. 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 substantially own the entity and that the entity's tax base is not substantially eroded by payments (directly or indirectly) to nonqualifying persons.

For purposes of this subparagraph 2(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. In Canada, the principles that are reflected in subsection 256(8.1) of the Income Tax Act will be applied, in effect treating memberships, policies or other interests in a corporation incorporated without share capital as representing an appropriate number of shares.

The look-through principles introduced by the Protocol (e.g. new paragraph 6 of Article IV) are to be taken into account when applying the ownership and base erosion provisions of Article XXIX A. Therefore, one "looks through" an entity that is viewed as fiscally transparent under the domestic laws of the residence State (other than entities that are resident in the source State) when applying the ownership/base erosion test. Assume, for example, that USCo, a company incorporated in the United States, wishes to obtain treaty benefits by virtue of the ownership and base erosion rule. USCo is owned by USLLC, an entity that is treated as fiscally transparent in the United States. USLLC in turn is wholly owned in equal shares by 10 individuals who are residents of the United States. Because the United States views USLLC as fiscally transparent, the 10 U.S. individuals shall be regarded as the owners of USCo for purposes of the ownership test. Accordingly, USCo would satisfy the ownership requirement of the ownership/base erosion test. However, if USLLC were instead owned in equal shares by four U.S. individuals and six individuals who are not residents of either the United States or

Canada, USCo would not satisfy the ownership requirement. Similarly, for purposes of the base erosion test, deductible payments made to USLLC will be treated as made to USLLC's owners.

Other qualifying persons

Under new subparagraph 2(f), an estate resident in the United States or Canada is a qualifying person entitled to the benefits of the Convention.

New subparagraphs 2(g) and 2(h) specify the circumstances under which certain types of not-for-profit organizations will be qualifying persons. Subparagraph 2(g) provides that a not-for-profit organization that is resident in the United States or Canada is a qualifying person, and thus entitled to benefits, if more than half of the beneficiaries, members, or participants in the organization are qualifying persons. The term "not-for-profit organization" of a Contracting State is defined in subparagraph 5(d) 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.

New subparagraph 2(h) specifies that certain trusts, companies, organizations, or other arrangements described in paragraph 2 of Article XXI (Exempt Organizations) are qualifying persons. To be a qualifying person, the trust, company, organization or other arrangement must be established for the purpose of providing pension, retirement, or employee benefits primarily to individuals who are (or were, within any of the five preceding years) qualifying persons. A trust, company, organization, or other arrangement will be considered to be established for the purpose of providing benefits primarily to such persons 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.

New subparagraph 2(i) specifies that certain trusts, companies, organizations, or other arrangements described in paragraph 3 of Article XXI (Exempt Organizations) are qualifying persons. To be a qualifying person, the beneficiaries of a trust, company, organization or other arrangement must be described in subparagraph 2(g) or 2(h).

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.

Paragraph 3 of Article XXIX A

Paragraph 3 provides an alternative rule, under which a United States or Canadian resident that is not a qualifying person under paragraph 2 may claim benefits with respect to those items of income that are connected with the active conduct of a trade or business in its State of residence.

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 person's activity and the connection between the income and that activity. Under the active trade or business test, a resident of a Contracting State deriving an item of income from the other Contracting State is entitled to benefits with respect to that income if that person (or a person related to that person under the principles of Code section 482, or in the case of Canada, section 251 of the Income Tax Act) is engaged in an active trade or business in the State where it is resident, the income in question is derived in connection with, or is incidental to, that trade or business, and the size of the active trade or business in the residence State is substantial relative to the activity in the other State that gives rise to the income for which benefits are sought. Further details on the application of the substantiality requirement are provided below.

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 if, for example, the income-generating activity in the State is "upstream," "downstream," or parallel to that conducted in the other Contracting State. Thus, for example, if the U.S. activity of a Canadian resident company 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 a trade or business if, for example, it arises from the short-term investment of working capital of the resident in securities issued by persons in the State of source.

An item of income may be considered to be earned in connection with or to be incidental to an active trade or business in the United States or Canada even though the resident claiming the benefits derives the income directly or indirectly through one or more other persons that are residents of the other Contracting State. 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 resident to derive income from the other Contracting State through one or more residents of that other State 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 unavailable 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 Code section 482.

As described above, income that is derived in connection with, or is incidental to, an active trade or business in a Contracting State, must pass the substantiality requirement to qualify for benefits under the Convention. The trade or business must be substantial in relation to the activity in the other Contracting State that gave rise to the income in respect of which benefits under the Convention are being claimed. To be

considered substantial, it is not necessary that the trade or business be as large as the income-generating activity. The 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 activity in the other State.

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 (Dividends) of the Convention. 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.

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.

Paragraph 4 of Article XXIX A

Paragraph 4 provides a limited "derivative benefits" test that entitles a company that is a resident of the United States or Canada to 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. In general, a derivative benefits test entitles the resident of a Contracting State to treaty benefits if the owner of the resident would have been entitled to the same benefit had the income in question been earned directly by that owner. To qualify under this paragraph, the company must satisfy both the ownership test in subparagraph 4(a) and the base erosion test of subparagraph 4(b).

Under subparagraph 4(a), the derivative benefits ownership test requires that the company's shares representing more than 90 percent of the aggregate vote and value of all of the shares of the company, and at least 50 percent of the vote and value of any disproportionate class of shares, in neither case including debt substitute shares, be owned directly or indirectly by persons each of whom is either (i) a qualifying person or (ii) another person that satisfies each of three tests. The three tests of subparagraph 4(a) that must be satisfied by these other persons are as follows:

First, the other person must be a resident of a third State with which the Contracting State that is granting benefits has a comprehensive income tax convention. The other person must 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 other 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 Article XXIX A, if the person were a resident of the Contracting State that is not providing benefits for the item of income and, for purposes of paragraph 3, the business were carried on in that State. 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 Article XXIX A if the principal class of its shares were primarily and regularly traded on a stock exchange recognized either under the Convention between the United States and Canada or under the treaty between the Contracting State granting benefits 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 the company's tax base were not substantially eroded by payments (directly or indirectly) to nonqualifying persons.

The third requirement is that the rate of 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 Contracting State granting benefits as it is under the Convention.

Subparagraph 4(b) sets forth the base erosion test. This test requires that the amount of expenses that are paid or payable by the company in question, directly or indirectly, to persons that are not qualifying persons under the Convention, and that are deductible from gross income (with both deductibility and gross income as determined under the tax laws of the State of residence of the company), be less than 50 percent of the gross income of the company. This test is applied for the fiscal period immediately preceding the period for which the test is being applied. If it is the first fiscal period of the person, the test is applied for the current period. This test is qualitatively the same as the base erosion test of subparagraph 2(e).

Paragraph 5 of Article XXIX A

Paragraph 5 defines certain terms used in the Article. These terms were identified and discussed in connection with new paragraph 2, above.

Paragraph 6 of Article XXIX A

Paragraph 6 provides that when a resident of a Contracting State derives income from the other Contracting State 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 competent authority of the other Contracting State. This determination can be made with respect to all benefits under the Convention or on an item by item basis. 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. If the competent authority of the other

Contracting State determines that either of these two standards is satisfied, benefits shall be granted.

For purposes of implementing new paragraph 6, a taxpayer will be permitted to present his case to the competent authority for an advance determination based on a full disclosure of all pertinent information. 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 provision of the Convention 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).

Paragraph 7 of Article XXIX A

New paragraph 7 is in substance similar to paragraph 7 of Article XXIX A of the existing Convention and clarifies the application of general anti-abuse provisions. New paragraph 7 provides that paragraphs 1 through 6 of Article XXIX A shall not be construed as limiting in any manner the right of a Contracting State to deny benefits under the Convention where it can reasonably be concluded that to do otherwise would result in an abuse of the provisions of the Convention. This provision permits a Contracting State to rely on general anti-avoidance rules to counter arrangements involving treaty shopping through the other Contracting State.

Thus, Canada may apply its domestic law rules to counter abusive arrangements involving "treaty shopping" through the United States, and the United States may apply its substance-over-form and anti-conduit rules, for example, in relation to Canadian residents. This principle is recognized by the OECD 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 statement of this principle explicitly in the Protocol is not intended to suggest that the principle is not also inherent in other tax conventions concluded by the United States or Canada.

Article 26

Article 26 of the Protocol replaces paragraphs 1 and 5 of Article XXIX B (Taxes Imposed by Reason of Death) of the Convention. In addition, paragraph 7 of the General Note provides certain clarifications for purposes of paragraphs 6 and 7 of Article XXIX B.

Paragraph 1

Paragraph 1 of Article XXIX B of the existing Convention generally addresses the situation where a resident of a Contracting State passes property by reason of the individual's death to an organization referred to in paragraph 1 of Article XXI (Exempt Organizations) of the Convention. The paragraph provided that the tax consequences in a Contracting State arising out of the passing of the property shall apply as if the organization were a resident of that State.

The Protocol replaces paragraph 1, and the changes set forth in new paragraph 1 are intended to specifically address questions that have arisen about the application of former paragraph 1 where property of an individual who is a resident of Canada passes by reason of the individual's death to a charitable organization in the United States that is not a "registered charity" under Canadian law. Under one view, paragraph 1 of Article

XXIX B requires Canada to treat the passing of the property as a contribution to a "registered charity" and thus to allow all of the same deductions for Canadian tax purposes as if the U.S. charity had been a "registered charity" under Canadian law. Under another view, paragraph 6 of Article XXI (Exempt Organizations) of the Convention continues to limit the amount of the income tax charitable deduction in Canada to the individual's income arising in the United States. The changes set forth in new paragraph 1 are intended to provide relief from the Canadian tax on gain deemed recognized by reason of death that would otherwise give rise to Canadian tax when the individual passes the property to a charitable organization in the United States, but, for purposes of the separate Canadian income tax, do not eliminate the limitation under paragraph 6 of Article XXI on the amount of the deduction in Canada for the charitable donation to the individual's income arising in the United States.

As revised, paragraph 1 is divided into two subparagraphs. New subparagraph 1(a) applies where property of an individual who is a resident of the United States passes by reason of the individual's death to a qualifying exempt organization that is a resident of Canada. In such case, the tax consequences in the United States arising from the passing of such property apply as if the organization were a resident of the United States. A bequest by a U.S. citizen or U.S. resident (as defined for estate tax purposes under the Code) to an exempt organization generally is deductible for U.S. federal estate tax purposes under Code section 2055, without regard to whether the organization is a U.S. corporation. Thus, generally, the individual's estate will be entitled to a charitable deduction for Federal estate tax purposes equal to the value of the property transferred to the organization. Generally, the effect is that no Federal estate tax will be imposed on the value of the property.

New subparagraph 1(b) applies where property of an individual who is a resident of Canada passes by reason of the individual's death to a qualifying exempt organization that is a resident of the United States. In such case, for purposes of the Canadian capital gains tax imposed at death, the tax consequences arising out of the passing of the property shall apply as if the individual disposed of the property for proceeds equal to an amount elected on behalf of the individual. For this purpose, the amount elected shall be no less than the individual's cost of the property as determined for purposes of Canadian tax, and no greater than the fair market value of the property. The manner in which the individual's representative shall make this election shall be specified by the competent authority of Canada. Generally, in the event of a full exercise of the election under new subparagraph 1(b), no capital gains tax will be imposed in Canada by reason of the death with regard to that property.

New paragraph 1 does not address the situation in which a resident of one Contracting State bequeaths property with a situs in the other Contracting State to a qualifying exempt organization in the Contracting State of the decedent's residence. In such a situation, the other Contracting State may impose tax by reason of death, for example, if the property is real property situated in that State.

Paragraph 2

Paragraph 2 of Article 26 of the Protocol replaces paragraph 5 of Article XXIX B of the existing Convention. The provisions of new paragraph 5 relate to the operation of Canadian law. Because Canadian law requires both spouses to have been Canadian residents in order to be eligible for the rollover, these provisions 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.

New paragraph 5 adds a reference to subsection 70(5.2) of the Canadian Income Tax Act. This change is needed because the rollover in respect of certain kinds of property is provided in that subsection. Further, new paragraph 5 adds a clause "and with respect to such property" near the end of the second sentence to make it clear that the trust is treated as a resident of Canada only with respect to its Canadian property.

For example, assume that a U.S. decedent with a Canadian spouse sets up a qualified domestic trust holding U.S. and Canadian real property, and that the decedent's executor elects, for Federal estate tax purposes, to treat the entire trust as qualifying for the Federal estate tax marital deduction. Under Canadian law, because the decedent is not a Canadian resident, Canada would impose capital gains tax on the deemed disposition of the Canadian real property immediately before death. In order to defer the Canadian tax that might otherwise be imposed by reason of the decedent's death, under new paragraph 5 of Article XXIX B, the competent authority of Canada shall, at the request of the trustee, treat the trust as a Canadian spousal trust with respect to the Canadian real property. The effect of such treatment is to defer the tax on the deemed distribution of the Canadian real property until an appropriate triggering event such as the death of the surviving spouse.

Paragraph 7 of the General Note

In addition to the foregoing, paragraph 7 of the General Note provides certain clarifications for purposes of paragraphs 6 and 7 of Article XXIX B. These clarifications ensure that tax credits will be available in cases where there are inconsistencies in the way the two Contracting States view the income and the property.

Subparagraph 7(a) of the General Note applies where an individual who immediately before death was a resident of Canada held at the time of death a share or option in respect of a share that constitutes property situated in the United States for the purposes of Article XXIX B and that Canada views as giving rise to employment income (for example, a share or option granted by an employer). The United States imposes estate tax on the share or option in respect of a share, while Canada imposes income tax on income from employment. Subparagraph 7(a) provides that for purposes of clause 6(a)(ii) of Article XXIX B, any employment income in respect of the share or option constitutes income from property situated in the United States. This provision ensures that the estate tax paid on the share or option in the United States will be allowable as a deduction from the Canadian income tax.

Subparagraph 7(b) of the General Note applies where an individual who immediately before death was a resident of Canada held at the time of death a registered retirement savings plan (RRSP) or other entity that is a resident of Canada and that is described in subparagraph 1(b) of Article IV (Residence) and such RRSP or other entity held property situated in the United States for the purposes of Article XXIX B. The United States would impose estate tax on the value of the property held by the RRSP or other entity (to the extent such property is subject to Federal estate tax), while Canada would impose income tax on a deemed distribution of the property in the RRSP or other entity. Subparagraph 7(b) provides that any income out of or under the entity in respect of the property is, for the purpose of subparagraph 6(a)(ii) of Article XXIX B, income

from property situated in the United States. This provision ensures that the estate tax paid on the underlying property in the United States (if any) will be allowable as a deduction from the Canadian income tax.

Subparagraph 7(c) of the General Note applies where an individual who immediately before death was a resident or citizen of the United States held at the time of death an RRSP or other entity that is a resident of Canada and that is described in subparagraph 1(b) of Article IV (Residence). The United States would impose estate tax on the value of the property held by the RRSP or other entity, while Canada would impose income tax on a deemed distribution of the property in the RRSP or other entity. Subparagraph 7(c) provides that for the purpose of paragraph 7 of Article XXIX B, the tax imposed in Canada is imposed in respect of property situated in Canada. This provision ensures that the Canadian income tax will be allowable as a credit against the U.S. estate tax.

Article 27

Article 27 of the Protocol provides the entry into force and effective date of the provisions of the Protocol.

Paragraph 1

Paragraph 1 provides generally that the Protocol is subject to ratification in accordance with the applicable procedures in the United States and Canada. Further, the Contracting States shall notify each other by written notification, through diplomatic channels, when their respective applicable procedures have been satisfied.

Paragraph 2

The first sentence of paragraph 2 generally provides that the Protocol shall enter into force on the date of the later of the notifications referred to in paragraph 1, or January 1, 2008, whichever is later. The relevant date is the date on the second of these notification documents, and not the date on which the second notification is provided to the other Contracting State. The January 1, 2008 date is intended to ensure that the provisions of the Protocol will generally not be effective before that date.

Subparagraph 2(a) provides that the provisions of the Protocol shall have effect in respect of taxes withheld at source, for amounts paid or credited on or after the first day of the second month that begins after the date on which the Protocol enters into force. Further, subparagraph 2(b) provides that the Protocol shall have effect in respect of other taxes, for taxable years that begin after (or, if the later of the notifications referred to in paragraph 1 is dated in 2007, taxable years that begin in and after) the calendar year in which the Protocol enters into force. These provisions are generally consistent with the formulation in the U.S. Model treaty, with the exception that a parenthetical was added in subparagraph 2(b) to address the contingency that the written notifications provided pursuant to paragraph 1 may occur in the 2007 calendar year. Further, subparagraph 3(d) of Article 27 of the Protocol contains special provisions with respect to the taxation of cross-border interest payments that have effect for the first two calendar years that end after the date the Protocol enters into force. Therefore, during this period, cross-border interest payments are not subject to the effective date provisions of subparagraph 2(a).

Paragraph 3

Paragraph 3 sets forth exceptions to the general effective date rules set forth in paragraph 2 of Article 27 of the Protocol.

Dual corporate residence tie-breaker

Subparagraph 3(a) of Article 27 of the Protocol provides that paragraph 1 of Article 2 of the Protocol relating to Article IV (Residence) shall have effect with respect to corporate continuations effected after September 17, 2000. This date corresponds to a press release issued on September 18, 2000 in which the United States and Canada identified certain issues with respect to these transactions and stated their intention to negotiate a protocol that, if approved, would address the issues effective as of the date of the press release.

Certain payments through fiscally transparent entities

Subparagraph 3(b) of Article 27 of the Protocol provides that new paragraph 7 of Article IV (Residence) set forth in paragraph 2 of Article 2 of the Protocol shall have effect as of the first day of the third calendar year that ends after the Protocol enters into force.

Permanent establishment from the provision of services

Subparagraph 3(c) of Article 27 of the Protocol sets forth the effective date for the provisions of Article 3 of the Protocol, pertaining to Article V (Permanent Establishment) of the Convention. The provisions pertaining to Article V shall have effect as of the third taxable year that ends after the Protocol enters into force, but in no event shall it apply to include, in the determination of whether an enterprise is deemed to provide services through a permanent establishment under paragraph 9 of Article V of the Convention, any days of presence, services rendered, or gross active business revenues that occur or arise prior to January 1, 2010. Therefore, the provision will apply beginning no earlier than January 1, 2010 and shall not apply with regard to any presence, services or related revenues that occur or arise prior to that date.

Withholding rates on cross-border interest payments

Subparagraph 3(d) of Article 27 of the Protocol sets forth special effective date rules pertaining to Article 6 of the Protocol relating to Article XI (Interest) of the Convention. Article 6 of the Protocol sets forth a new Article XI of the Convention that provides for exclusive residence State taxation regardless of the relationship between the payer and the beneficial owner of the interest. Subparagraph 3(d), however, phases in the application of paragraph 1 of Article XI during the first two calendar years that end after the date the Protocol enters into force. During that period, paragraph 1 of Article XI of the Convention permits source State taxation of interest if the payer and the beneficial owner are related or deemed to be related by reason of paragraph 2 of Article IX (Related Persons) of the Convention ("related party interest"), and the interest would not otherwise be exempt under the provisions of paragraph 3 of Article XI as it read prior to the Protocol. However, subparagraph 3(d) also provides that the source State taxation on such related party interest is limited to 7 percent in the first calendar year that ends after entry into force of the Protocol and 4 percent in the second calendar year that ends after entry into force of the Protocol.

Subparagraph 3(d) makes clear that the provisions of the Protocol with respect to exclusive residence based taxation of interest when the payer and the beneficial owner are not related or deemed related ("unrelated party interest") applies for interest paid or credited during the first two calendar years that end after entry into force of the Protocol.

The withholding rate reductions for related party interest and exemptions for unrelated party interest will likely apply retroactively. For example, if the Protocol enters into force on June 30, 2008, paragraph 1 of Article XI, as it reads under subparagraph 3(d) of Article 27, will have the following effect during the first two calendar years. First, unrelated party interest that is paid or credited on or after January 1, 2008 will be exempt from taxation in the source State. Second, related party interest paid or credited on or after January 1, 2008 and before January 1, 2009, will be subject to source State taxation but at a rate not to exceed 7 percent of the gross amount of the interest. Third, related party interest paid or credited on or after January 1, 2009 and before January 1, 2010, will be subject to source State taxation but at a rate not to exceed 4 percent of the gross amount of the interest. Finally, all interest paid or credited after January 1, 2010, will be subject to the regular rules of Article XI without regard to subparagraph 3(d) of Article 27.

Further, the provisions of subparagraph 3(d) ensure that even with respect to circumstances where the payer and the beneficial owner are related or deemed related under the provisions of paragraph 2 of Article IX, the source State taxation of such cross-border interest shall be no greater than the taxation of such interest prior to the Protocol.

Gains

Subparagraph 3(e) of Article 27 of the Protocol provides the effective date for paragraphs 2 and 3 of Article 8 of this Protocol, which relate to the changes made to paragraphs 5 and 7 of Article XIII (Gains) of the Convention. The changes set forth in those paragraphs shall have effect with respect to alienations of property that occur (including, for greater certainty, those that are deemed under the law of a Contracting State to occur) after September 17, 2000. This date corresponds to the press release issued on September 18, 2000 which announced the intention of the United States and Canada to negotiate a protocol that, if approved, would incorporate the changes set forth in these paragraphs to coordinate the tax treatment of an emigrant's gains in the United States and Canada.

Arbitration

Subparagraph 3(f) of Article 27 of the Protocol pertains to Article 21 of the Protocol which implements the new arbitration provisions. An arbitration proceeding will generally begin two years after the date on which the competent authorities of the Contracting States began consideration of a case. Subparagraph 3(f), however, makes clear that the arbitration provisions shall apply to cases that are already under consideration by the competent authorities when the Protocol enters into force, and in such cases, for purposes of applying the arbitration provisions, the commencement date shall be the date the Protocol enters into force. Further, the provisions of Article 21 of the Protocol shall be effective for cases that come into consideration by the competent authorities after the date that the Protocol enters into force. In order to avoid the potential for a large number of MAP cases becoming subject to arbitration immediately upon the expiration of two years from entry into force, the competent authorities are encouraged to develop and implement procedures for arbitration by January 1, 2009, and begin scheduling arbitration of otherwise unresolvable MAP cases in inventory (and meeting the agreed criteria) prior to two years from entry into force.

Assistance in collection

Subparagraph 3(g) of Article 27 of the Protocol pertains to the date when the changes set forth in Article 22 of the Protocol, relating to assistance in collection of taxes,

shall have effect. Consistent with the third protocol that entered into force on November 9, 1995, and which had effect for requests for assistance on claims finally determined after November 9, 1985, the provisions of Article 22 of the Protocol shall have effect for revenue claims finally determined by an applicant State after November 9, 1985.

DEPARTMENT OF THE TREASURY
TECHNICAL EXPLANATION OF
THE CONVENTION BETWEEN
THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND
THE GOVERNMENT OF ICELAND
FOR THE AVOIDANCE OF DOUBLE TAXATION AND
THE PREVENTION OF FISCAL EVASION
WITH RESPECT TO TAXES ON INCOME.

This is a technical explanation of the Convention between the Government of the United States and the Government of Iceland For the Avoidance Of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed on October 23, 2007 (the "Convention").

Negotiations took into account the U.S. Treasury Department's current tax treaty policy, and the Treasury Department's Model Income Tax Convention. Negotiations also took into account the Model Tax Convention on Income and on Capital, published by the Organisation for Economic Cooperation and Development (the "OECD Model"), and recent tax treaties concluded by both countries.

The Technical Explanation is an official guide to the Convention and an accompanying Protocol. It reflects the policies behind particular Convention and Protocol provisions, as well as understandings reached during the negotiations with respect to the application and interpretation of the Convention and Protocol. References in the Technical Explanation to "he" or "his" should be read to mean "he or she" or "his and her."

ARTICLE 1 (GENERAL SCOPE)

Paragraph 1

Paragraph 1 of Article 1 provides that the Convention applies only to residents of the United States or Iceland except where the terms of the Convention provide otherwise. Under Article 4 (Resident) a person is generally 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, citizenship, residence, or other similar criteria. However, if a person is considered a resident of both Contracting States, Article 4 provides rules for determining a State of residence (or no State of residence). This determination governs for all purposes of the Convention.

Certain provisions are applicable to persons who may not be residents of either Contracting State. For example, paragraph 1 of Article 23 (Non-Discrimination) applies to nationals of the Contracting States. Under Article 25 (Exchange of Information and Administrative Assistance), information may be exchanged with respect to residents of third states.

Paragraph 2

Paragraph 2 states the generally accepted relationship both between the Convention and domestic law and between the Convention and other agreements between the Contracting States. That is, no provision in the Convention may restrict any exclusion, exemption, deduction, credit or other benefit accorded by the tax laws of the Contracting States, or by any other agreement between the Contracting States. The relationship between the non-discrimination provisions of the Convention and other agreements is addressed not in paragraph 2 but in paragraph 3.

Under paragraph 2, for example, if a deduction would be allowed under the U.S. Internal Revenue Code (the "Code") in computing the U.S. taxable income of a resident of Iceland, the deduction also is allowed to that person in computing taxable income under the Convention. Paragraph 2 also means that the Convention may not increase the tax burden on a resident of a Contracting States beyond the burden determined under domestic law. Thus, a right to tax given by the Convention cannot be exercised unless that right also exists under internal law.

It follows that, under the principle of paragraph 2, a taxpayer's U.S. tax liability need not be determined under the Convention if the Code would produce a more favorable result. A taxpayer may not, however, choose among the provisions of the Code and the Convention in an inconsistent manner in order to minimize tax. Thus, a taxpayer may use the Convention to reduce its taxable income, but may not use both treaty and Code rules where doing so would thwart the intent of either set of rules. For example, assume that a resident of Iceland 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 taxable income under the Code but 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 in the United States, and both the profit and loss of the other two businesses are ignored. Under the Code, all three would be subject to tax, but the loss would offset 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. 308.) If, however, 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.

Similarly, nothing in the Convention can be used to deny any benefit granted by any other agreement between the United States and Iceland. For example, if certain benefits are provided for military personnel or military contractors under a Status of Forces Agreement between the United States and Iceland, those benefits or protections will be available to residents of the Contracting States regardless of any provisions to the contrary (or silence) in the Convention.

Paragraph 3

Paragraph 3 specifically relates to non-discrimination obligations of the Contracting States under other agreements. 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 benefit now or hereafter accorded by any other agreement between the Contracting States.

Subparagraph 3(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 that 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 purposes of determining the scope of the Convention.

Subparagraph 3(b) provides that, unless the competent authorities determine that a taxation measure is not within the scope of this Convention, the non-discrimination 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.

Paragraph 4

Paragraph 4 contains the traditional saving clause found in all U.S. treaties. The Contracting States reserve their rights, except as provided in paragraph 5, to tax their residents and citizens as provided in their internal laws, notwithstanding any provisions of the Convention to the contrary. For example, if a resident of Iceland performs professional services in the United States and the income from the services is not attributable to a permanent establishment in the United States, Article 7 (Business Profits) would by its terms prevent the United States from taxing the income. If, however, the resident of Iceland 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 (*i.e.*, without regard to Code section 894(a)). However, subparagraph 5(a) of Article 1 preserves the benefits of special foreign tax credit rules applicable to the U.S. taxation of certain U.S. income of its citizens resident in Iceland. See paragraph 4 of Article 22 (Relief from Double Taxation).

For purposes of the saving clause, "residence" is determined under Article 4. Thus, an individual who is a resident of the United States under the Code (but not a U.S. citizen) but who is determined to be a resident of Iceland under the tie-breaker rules of Article 4 would be subject to U.S. tax only to the extent permitted by the Convention. The United States would not be permitted to apply its statutory rules to that person to the extent the rules are inconsistent with the Convention.

However, the person would be treated as a U.S. resident for U.S. tax purposes other than determining the individual's U.S. tax liability. For example, in determining under Code section 957 whether a foreign corporation is a controlled foreign corporation, shares in that corporation held by the individual would be considered to be held by a U.S. resident. As a result, other U.S. citizens or residents might be deemed to be United States shareholders of a controlled foreign corporation subject to current inclusion of Subpart F income recognized by the corporation. See, Treas. Reg. section 301.7701(b)-7(a)(3).

Under paragraph 4, the United States also reserves its right to tax former citizens and former long-term residents for a period of ten years following the loss of such status. Thus, paragraph 4 allows the United States to tax former U.S. citizens and former U.S. long-term residents in accordance with Section 877 of the Code. Section 877 generally applies to a former citizen or long-term resident of the United States who relinquishes citizenship or terminates long-term residency before June 17, 2008 if either of the following criteria exceed established thresholds: (a) the average annual net income tax of such individual for the period of 5 taxable years ending before the date of the loss of status, or (b) the net worth of such individual as of the date of the loss of status.

The United States defines "long-term resident" as an individual (other than a U.S. citizen) who is a lawful permanent resident of the United States in at least 8 of the prior 15 taxable years. An individual is not treated as a lawful permanent resident for any taxable year in which the individual is treated as a resident of Iceland under this Convention, or as a resident of any country other than the United States under the provisions of any other tax treaty of the United States, and in either case the individual does not waive the benefits of the relevant convention.

Paragraph 5

Paragraph 5 sets forth certain exceptions to the saving clause. The referenced provisions are intended to provide benefits to citizens and residents even if such benefits do not exist under internal law. Paragraph 5 thus preserves these benefits for citizens and residents of the Contracting States.

Subparagraph 5(a) lists certain provisions of the Convention that are applicable to all citizens and residents of a Contracting State, despite the general saving clause rule of paragraph 4:

(1) Paragraph 2 of Article 9 (Associated Enterprises) grants the right to a correlative adjustment with respect to income tax due on profits reallocated under Article 9.

(2) Paragraphs 2 and 4 of Article 17 (Pensions, Social Security, and Annuities) provide exemptions from source or residence State taxation for certain pension distributions and social security payments.

(3) Article 22 (Relief from Double Taxation) confirms to citizens and residents of one Contracting State the benefit of a credit for income taxes paid to the other or an exemption for income earned in the other State.

(4) Article 23 (Non-Discrimination) protects residents and nationals of one Contracting State against the adoption of certain discriminatory practices in the other Contracting State.

(5) Article 24 (Mutual Agreement Procedure) confers certain benefits on citizens and residents of the Contracting States in order to reach and implement solutions to disputes between the two Contracting States. For example, the competent authorities are permitted to use a definition of a term that differs from an internal law definition. The statute of limitations may be waived for refunds, so that the benefits of an agreement may be implemented.

Subparagraph 5(b) provides a different set of exceptions to the saving clause. The benefits referred to are all intended to be granted to temporary residents of a Contracting State (for example, in the case of the United States, holders of non-immigrant visas), but not to citizens or to persons who have acquired permanent residence in that State. If beneficiaries of these provisions travel from one of the Contracting States to the other, and remain in the other long enough to become residents under its internal law, but do not acquire permanent residence status (i.e., in the U.S. context, they do not become "green card" holders) and are not citizens of that State, the host State will continue to grant these benefits even if they conflict with the statutory rules. The benefits preserved by this paragraph are: (1) the host country exemptions for government service salaries and pensions under Article 18 (Government Service), certain income of visiting students and trainees under Article 19 (Students and Trainees), and the income of diplomatic agents and consular officers under Article 26 (Members of Diplomatic Missions and Consular Posts).

Paragraph 6

Paragraph 6 provides that an item of income derived by a fiscally transparent entity is considered to be derived by a resident of a Contracting State to the extent that the resident is treated under the taxation laws of the State where he is resident as deriving the item of income. This paragraph applies to any resident of a Contracting State who is entitled to income derived through an entity that is treated as fiscally transparent under the laws of either Contracting State. For example, if a corporation resident in Iceland distributes a dividend to an entity that is treated as fiscally transparent for U.S. tax purposes, the dividend will be considered derived by a resident of the United States only to the extent that the taxation laws of the United States treat one or more U.S. residents (whose status as U.S. residents is determined, for this purpose, under U.S. tax laws) as deriving the dividend income for U.S. tax purposes. In the case of a partnership, the persons who are, under U.S. tax laws, treated as partners of the entity would normally be the persons whom the U.S. tax laws would treat as deriving the dividend income through the partnership. Thus, it also follows that persons whom the United States treats as partners but who are not U.S. residents for U.S. tax purposes may not claim a benefit under the Convention for the dividend paid to the entity. Although these partners are treated as deriving the income for U.S. tax purposes, they are not residents of the United States for purposes of the treaty. If, however, they are treated as residents of a third country under the provisions of an income tax convention which that country has with Iceland, they may be entitled to claim a benefit under that convention. In contrast, if an entity is organized under U.S. laws and is classified as a corporation for U.S. tax purposes, dividends paid by a corporation resident in Iceland to the U.S. entity will be considered derived by a resident of the United States since the U.S. corporation is treated under U.S. taxation laws as a resident of the United States and as deriving the income.

Because the entity classification rules of the State of residence govern, the results in the examples discussed above would obtain even if the entity were viewed differently under the tax laws of Iceland (e.g., as not fiscally transparent in the first example above where the entity is treated as a partnership for U.S. tax purposes or as fiscally transparent in the second example where the entity is viewed as not fiscally transparent for U.S. tax purposes). Moreover, these results follow regardless of whether the entity is organized in the United States, Iceland, or in a third country. For example, income from sources in Iceland received by an entity organized under the laws of Iceland, which is treated for U.S. tax purposes as a corporation and is owned by a U.S. shareholder who is a U.S. resident for U.S. tax purposes, is not considered derived by the shareholder of that corporation even if, under the tax laws of Iceland, the entity is treated as fiscally transparent. These results also follow regardless of whether the entity is disregarded as a

separate entity under the laws of one jurisdiction but not the other, such as a single owner entity that is viewed as a branch for U.S. tax purposes and as a corporation for tax purposes of in Iceland.

Where income is derived through an entity organized in a third state that has owners resident in one of the Contracting States, the characterization of the entity in that third state is irrelevant for purposes of determining whether the resident is entitled to treaty benefits with respect to income derived by the entity.

In general, paragraph 6 relates to entities that are not subject to tax at the entity level, as distinct from entities that are subject to tax, but with respect to which tax may be relieve under an integrated system. Entities falling under this description in the United States include partnerships, common investment trusts under section 584 and grantor trusts. This paragraph also applies to U.S. limited liability companies (("LLCs"), including an LLC with only one member), that are treated as partnerships or as disregarded entities for U.S. tax purposes. The taxation laws of a Contracting State may treat an item of income as income of a resident of that State even if the resident is not subject to tax on that particular item of income. For example, if a Contracting State has a participation exemption for certain foreign-source dividends and capital gains, such income or gains would be regarded as income or gain of a resident of that State who otherwise derived the income or gain, despite the fact that the resident could be exempt from tax in that State on the income or gain.

Paragraph 6 is not an exception to the saving clause of paragraph 4. Accordingly, paragraph 6 does not prevent a Contracting State from taxing an entity that is treated as a resident of that State under its own tax law. For example, if a U.S. LLC with members who are residents of Iceland elects to be taxed as a corporation for U.S. tax purposes, the United States will tax that LLC on its worldwide income on a net basis, without regard to whether Iceland views the LLC as fiscally transparent.

ARTICLE 2 (TAXES COVERED)

This Article specifies the U.S. taxes and the taxes of Iceland to which the Convention applies. With two exceptions, the taxes specified in Article 2 are the covered taxes for all purposes of the Convention. A broader coverage applies for purposes of Articles 23 (Non-Discrimination) and 25 (Exchange of Information and Administrative Assistance). Article 23 applies with respect to all taxes, including those imposed by state and local governments. Article 25 applies with respect to all taxes imposed at the national level.

Paragraph 1

Paragraph 1 identifies the category of taxes to which the Convention applies. Paragraph 1 is based on the U. S. and OECD Models and defines the scope of application of the Convention. The Convention applies to taxes on income, including gains, imposed on behalf of a Contracting State, irrespective of the manner in which they are levied. Except with respect to Article 23 state and local taxes are not covered by the Convention.

Paragraph 2

Paragraph 2 also is based on the U.S. and OECD Models and provides a definition of taxes on income, on capital and on capital gains. The Convention covers taxes on total income, on total capital, or any part of income and includes tax on gains derived from the alienation of

property. The Convention does not apply, however, to social security charges, or any other charges where there is a direct connection between the levy and individual benefits. Social security and unemployment taxes (Code sections 1401, 3101, 3111 and 3301) are excluded from coverage. The Convention also does not apply to property taxes, except with respect to Article 23.

Paragraph 3

Paragraph 3 lists the taxes in force at the time of signature of the Convention to which the Convention applies.

The existing covered taxes of Iceland are identified in subparagraph 3(a). These taxes are i) the income taxes to the state and ii) the income taxes to the municipalities.

Subparagraph 3(b) provides that the existing U.S. taxes subject to the rules of the Convention are the Federal income taxes imposed by the Code, together with the excise taxes imposed with respect to private foundations (Code sections 4940 through 4948)..

Paragraph 4

Under paragraph 4, the Convention will apply to any taxes that are identical, or substantially similar, to those enumerated in paragraph 3, and which are imposed in addition to, or in place of, the existing taxes after October 23, 2007, the date of signature of the Convention. The paragraph also provides that the competent authorities of the Contracting States will notify each other of any significant changes that have been made in their laws, whether tax laws or non-tax laws, that affect significantly their obligations under the Convention. Non-tax laws that may affect a Contracting State's obligations under the Convention may include, for example, laws affecting bank secrecy.

ARTICLE 3 (GENERAL DEFINITIONS)

Article 3 provides general definitions and rules of interpretation applicable throughout 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). These definitions are used consistently throughout the Convention. Other terms, such as "dividends," "interest" and "royalties" are defined in specific articles for purposes only of those articles.

Paragraph 1

Paragraph 1 defines a number of basic terms used in the Convention. The introduction to paragraph 1 makes clear that these definitions apply for all purposes of the Convention, unless the context requires otherwise. This latter condition allows flexibility in the interpretation of the treaty in order to avoid results not intended by the treaty's negotiators.

The geographical scope of the Convention with respect Iceland is set out in subparagraph 1(a). It encompasses the territory of Iceland, including its territorial sea, and any area beyond the territorial sea within which Iceland, in accordance with international law, exercises

jurisdiction or sovereign rights with respect to the sea bed, its subsoil and its adjacent waters, and their natural resources.

The geographical scope of the Convention with respect to the United States is set out in subparagraph 1(b). It encompasses the United States of America, including the states, the District of Columbia and the territorial sea of the United States. The term does not include Puerto Rico, the Virgin Islands, Guam or any other U.S. possession or territory. For certain purposes, the term "United States" includes the sea bed and subsoil of undersea areas adjacent to the territorial sea of the United States. This extension applies to the extent that the United States exercises sovereignty in accordance with international law for the purpose of natural resource exploration and exploitation of such areas. This extension of the definition applies, however, only if the person, property or activity to which the Convention is being applied is connected with such natural resource exploration or exploitation. Thus, it would not include any activity involving the sea floor of an area over which the United States exercised sovereignty for natural resource purposes if that activity was unrelated to the exploration and exploitation of natural resources. This result is consistent with the result that would be obtained under Section 638, which treats the continental shelf as part of the United States for purposes of natural resource exploration and exploitation.

Subparagraph 1(c) defines the term "person" to include an individual, a trust, a partnership, a company and any other body of persons. The definition is significant for a variety of reasons. For example, under Article 4, only a "person" can be a "resident" and therefore eligible for most benefits under the treaty. Also, all "persons" are eligible to claim relief under Article 24 (Mutual Agreement Procedure).

The term "company" is defined in subparagraph 1(d) as a body corporate or an entity treated as a body corporate for tax purposes in the state where it is organized. The definition refers to the law of the state in which an entity is organized in order to ensure that an entity that is treated as fiscally transparent in its country of residence will not get inappropriate benefits, such as the reduced withholding rate provided by subparagraph 2(b) of Article 10 (Dividends). It also ensures that the Limitation on Benefits provisions of Article 21 will be applied at the appropriate level.

Subparagraph 1(e) defines the term "enterprise" as any activity or set of activities that constitutes the carrying on of a business. The term "business" is not defined, but subparagraph (k) provides that it includes the performance of professional services and other activities of an independent character. Both subparagraphs are identical to definitions recently added to the OECD Model in connection with the deletion of Article 14 (Independent Personal Services) from the OECD Model. The inclusion of the two definitions is intended to clarify that income from the performance of professional services or other activities of an independent character is dealt with under Article 7 (Business Profits) and not Article 20 (Other Income).

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. An enterprise of a Contracting State need not be carried on in that State. It may be carried on in the other Contracting State or a third state (e.g., a U.S. corporation doing all of its business in the other Contracting State would still be a U.S. enterprise). Although not explicitly stated in the Convention, these terms also encompass an enterprise conducted through an entity (such as a partnership) that is treated as fiscally transparent in the Contracting State where the entity's owner is resident. In accordance with Article 4 (Resident), entities that are fiscally transparent in

the Contracting State in which their owners are resident are not considered to be residents of that State (although income derived by such entities may be taxed as the income of a resident, if taxed in the hands of resident partners or other owners). An enterprise conducted by such an entity will be treated as carried on by a resident of a Contracting State to the extent its partners or other owners are residents. This approach is consistent with the Code, which under section 875 attributes a trade or business conducted by a partnership to its partners and a trade or business conducted by an estate or trust to its beneficiaries.

Subparagraph 1(g) provides that the terms "a Contracting State" and "the other Contracting State" shall mean Iceland or the United States, as the context requires.

Subparagraph 1(h) 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. This definition is applicable principally in the context of Article 8 (Shipping and Air Transport). The definition combines with paragraphs 2 and 3 of Article 8 to exempt from tax by the source State income from the rental of ships or aircraft that is earned both by lessors that are operators of ships and aircraft and by those lessors that are not (e.g., a bank or a container leasing company).

The exclusion from international traffic of transport solely between places within a Contracting State means, for example, that carriage of goods or passengers solely between New York and Chicago would not be treated as international traffic, whether carried by a U.S. or a foreign carrier. 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. Thus, if the carrier engaged in internal U.S. traffic were a resident of Iceland (assuming that were possible under U.S. law), the United States would not be required to exempt the income from that transport 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 of the foreign carrier, and then only on a net basis. The gross basis U.S. tax imposed by section 887 would never apply under the circumstances described. If, however, goods or passengers are carried by a carrier resident in Iceland from a non-U.S. port to, for example, New York, and some of the goods or passengers continue on to Chicago, the entire transport would be international traffic. This would be true if the international carrier transferred the goods at the U.S. port of entry from a ship to a land vehicle, from a ship to a lighter, or even if the overland portion of the trip in the United States was handled by an independent carrier under contract with the original international carrier, so long as both parts of the trip were reflected in original bills of lading. For this reason, the Convention, following the U.S. Model, refers in the definition of "international traffic," to "such transport" being solely between places in the other Contracting State, while the OECD Model refers to the ship or aircraft being operated solely between such places. The formulation in the Convention is intended to make clear that, as in the above example, even if the goods are carried on a different aircraft for the internal portion of the international voyage than is used for the overseas portion of the trip, the definition applies to that internal portion as well as the external portion.

Finally, a "cruise to nowhere," i.e., a cruise beginning and ending in a port in the same Contracting State with no stops in a foreign port, would not constitute international traffic.

Subparagraph 1(i) designates the "competent authorities" for Iceland and the United States. In the case of Iceland, the competent authority is the Minister of Finance or his authorized representative. The U.S. competent authority is the Secretary of the Treasury or his

delegate. The Secretary of the Treasury has delegated the competent authority function to the Commissioner of Internal Revenue, who in turn has delegated the authority to the Deputy Commissioner (International) LMSB. With respect to interpretative issues, the Deputy Commissioner (International) LMSB acts with the concurrence of the Associate Chief Counsel (International) of the Internal Revenue Service.

The term "national," as it relates to the United States and to Iceland, is defined in subparagraph 1(j). This term is relevant for purposes of Articles 18 (Government Service) and 23 (Non-Discrimination). A national of one of the Contracting States is (1) an individual who is a citizen or national of that State, and (2) any legal person, partnership or association deriving its status, as such, from the law in force in the State where it is established.

Subparagraph 1(l) defines the term "pension scheme" to include any plan, scheme, fund, trust or other arrangement established in a Contracting State that is generally exempt from income taxation in that State and that is operated principally to administer or provide pension or retirement benefits or to earn income for the benefit of one or more such arrangements. Subparagraph 1(b) of the Protocol provides that in the case of the United States, the term "pension scheme" includes the following: a trust providing pension or retirement benefits under a Code section 401(a) qualified pension plan, profit sharing or stock bonus plan, a Code section 403(a) qualified annuity plan, a Code section 403(b) plan, a trust that is an individual retirement account under Code section 408, a Roth individual retirement account under Code section 408A, or a simple retirement account under Code section 408(p), a trust providing pension or retirement benefits under a simplified employee pension plan under Code section 408(k), a trust described in section 457(g) providing pension or retirement benefits under a Code section 457(b) plan, and the Thrift Savings Fund (section 7701(j)). Section 401(k) plans and group trusts described in Revenue Ruling 81-100 and meeting the conditions of Revenue Ruling 2004-67 qualify as pension funds to the extent they are Code section 401(a) plans or other pension schemes. In the case of Iceland, subparagraph 1(a) of the Protocol provides that the term "pension scheme" includes any pension fund or pension plan qualified under the Pension Act or any identical or substantially similar schemes which are created under any law enacted after October 23, 2007, the date of signature of the Convention.

Paragraph 2

Terms that are not defined in the Convention are dealt with in paragraph 2.

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 otherwise, or the competent authorities have agreed on a different meaning pursuant to Article 24 (Mutual Agreement Procedure). If the term is defined under both the tax and non-tax laws of a Contracting State, the definition in the tax law will take precedence over the definition in the non-tax laws. Finally, there also may be cases where the tax laws of a State contain multiple definitions of the same term. In such a case, the definition used for purposes of the particular provision at issue, if any, should be used.

If 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, as indicated in subparagraph 3(f) of Article 24, may establish a common meaning in order to prevent double taxation or to 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.

The reference in paragraph 2 to the internal law of a Contracting State means the law in effect at the time the treaty is being applied, not the law as in effect at the time the treaty was signed. The use of "ambulatory" definitions, however, may lead to results that are at variance with the intentions of the negotiators and of the Contracting States when the treaty was negotiated and ratified. The reference in both paragraphs 1 and 2 to the "context otherwise requir[ing]" a definition different from the treaty definition, in paragraph 1, or from the internal law definition of the Contracting State whose tax is being imposed, under paragraph 2, refers to a circumstance where the result intended by the Contracting States is different from the result that would obtain under either the paragraph 1 definition or the statutory definition. Thus, flexibility in defining terms is necessary and permitted.

ARTICLE 4 (RESIDENT)

This Article sets forth rules for determining whether a person is a resident of a Contracting State for purposes of the Convention. As a general matter only residents of the Contracting States may claim the benefits of the Convention. The treaty definition of residence is to be used only for purposes of the Convention. The fact that a person is determined to be a resident of a Contracting State under Article 4 does not necessarily entitle that person to the benefits of the Convention. In addition to being a resident, a person also must qualify for benefits under Article 21 (Limitation On Benefits) in order to receive benefits conferred on residents of a Contracting State.

The determination of residence for treaty purposes looks first to a person's liability to tax as a resident under the respective taxation laws of the Contracting States. As a general matter, 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. If, however, a person is resident in both Contracting States under their respective taxation laws, the Article proceeds, where possible, to use tie-breaker rules to assign a single State of residence to such a person for purposes of the Convention.

Paragraph 1

The term "resident of a Contracting State" is defined in paragraph 1. In general, this definition incorporates the definitions of residence in U.S. law and that of Iceland by referring to a resident as a person who, under the laws of a Contracting State, is subject to tax there by reason of his domicile, residence, citizenship, place of management, place of incorporation or any other similar criterion. Thus, residents of the United States include aliens who are considered U.S. residents under Code section 7701(b). Paragraph 1 also specifically includes the two Contracting States, and political subdivisions and local authorities of the two States, as residents for purposes of the Convention.

Certain entities that are nominally subject to tax but that in practice are rarely required to pay tax also would generally be treated as residents and therefore accorded treaty benefits. For example, a U.S. Regulated Investment Company (RIC) and a U.S. Real Estate Investment Trust (REIT) are residents of the United States for purposes of the treaty. Although the income earned by these entities normally is not subject to U.S. tax in the hands of the entity, they are taxable to the extent that they do not currently distribute their profits, and therefore may be regarded as

"liable to tax." They also must satisfy a number of requirements under the Code in order to be entitled to special tax treatment.

A person who is liable to tax in a Contracting State only in respect of income from sources within that State or capital situated therein or of profits attributable to a permanent establishment in that State will not be treated as a resident of that Contracting State for purposes of the Convention. Thus, a consular official of Iceland who is posted 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. source income (see Code section 7701(b)(5)(B)), would not be considered a resident of the United States for purposes of the Convention. Similarly, an enterprise of Iceland with a permanent establishment in the United States is not, by virtue of that permanent establishment, a resident of the United States. The enterprise generally is subject to U.S. tax only with respect to its income that is attributable to the U.S. permanent establishment, not with respect to its worldwide income, as it would be if it were a U.S. resident.

Paragraph 2

Paragraph 2 provides that certain tax-exempt entities such as pension schemes and charitable organizations will be regarded as residents of a Contracting State regardless of whether they are generally liable to income tax in the State where they are established. The inclusion of this provision is intended to clarify the generally accepted practice of treating an entity that would be liable for tax as a resident under the internal law of a State but for a specific exemption from tax (either complete or partial) as a resident of that State for purposes of paragraph 1.

Subparagraph 2(a) applies to pension schemes, as defined in subparagraph 1(l) of Article 3 (General Definitions). Subparagraph 2(b) applies to any plan, scheme, fund, trust, company or other arrangement established in a Contracting State that is generally exempt from taxation in that State because it is operated exclusively to administer or provide employee benefits. The reference to a general exemption is intended to reflect the fact that under U.S. law, certain organizations that generally are considered to be tax-exempt entities may be subject to certain excise taxes or to income tax on their unrelated business income. Subparagraph 2(c) applies to an organization that is established exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes and that is a resident of a Contracting State. Thus, a section 501(c) organization organized in the United States (such as a U.S. charity) that is generally exempt from tax under U.S. law is a resident of the United States for all purposes of the Convention.

Paragraph 3

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 are provided in paragraph 3 to determine a single State of residence for that individual. These tests are to be applied in the order in which they are stated. The first test is based on 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 a habitual abode. If he has a habitual abode in both States or in neither of them, he will be treated as a resident of the Contracting State of which he is a national. 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

Paragraph 4 seeks to settle dual residence issues for persons other than individuals (e.g., companies, trusts, or estates). For example, a dual residence may arise in the case of a company that is dually created in both the United States and Iceland or that is incorporated in the United States, and therefore treated as a resident of the United States, but that is also considered a resident of Iceland because it is managed and controlled in Iceland. In such a case, if such a person is, under the rules of paragraph 1, resident in both Contracting States, the competent authorities shall seek to determine a single State of residence for that person for purposes of the Convention. If the competent authorities do not reach an agreement on a single State of residence, that company may not claim any benefit accorded to residents of a Contracting State by the Convention, except those provided in Article 23 (Non-Discrimination) and Article 24 (Mutual Agreement Procedure). Thus, for example, a State cannot impose discriminatory tax measures on a dual resident company.

Dual resident companies may be treated as a resident of a Contracting State for purposes other than that of obtaining benefits under the Convention. For example, if a dual resident company pays a dividend to a resident of Iceland, the U.S. paying agent would withhold on that dividend at the appropriate treaty rate because reduced withholding is a benefit enjoyed by the resident of Iceland, not by the dual resident company. The dual resident company that paid the dividend would, for this purpose, be treated as a resident of the United States under the Convention. In addition, information relating to dual resident companies can be exchanged under the Convention because, by its terms, Article 26 (Exchange of Information and Administrative Assistance) is not limited to residents of the Contracting States.

ARTICLE 5 (PERMANENT ESTABLISHMENT)

This Article defines the term "permanent establishment," a term that is significant for 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. 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 that the recipient has in the source State. The concept is also relevant in determining which Contracting State may tax certain gains under Article 13 (Capital Gains) and certain "other income" under Article 20 (Other Income).

Paragraph 1

The basic definition of the term "permanent establishment" is contained in paragraph 1. 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. As indicated in the OECD Commentary to Article 5 (see paragraphs 4 through 8), a general principle to be observed in determining whether a permanent establishment exists is that the place of business must be "fixed" in the sense that a particular building or physical location is used by the enterprise for the conduct of its business,

and that it must be foreseeable that the enterprise's use of this building or other physical location will be more than temporary.

Paragraph 2

Paragraph 2 lists a number of types of fixed places of business that constitute a permanent establishment. This list is illustrative and non-exclusive. 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

This paragraph provides rules to determine whether a building site or a construction, assembly or installation project, or an installation or drilling rig or ship used for the exploration of natural resources constitutes a permanent establishment for the contractor, driller, etc. Such a site or activity does not create a permanent establishment unless the site, project, etc. lasts, or the exploration activity continues, for more than twelve months. It is only necessary to refer to "exploration" and not "exploitation" in this context because exploitation activities are defined to constitute a permanent establishment under subparagraph 2(f). Thus, a drilling rig does not constitute a permanent establishment if a well is drilled in only six months, but if production begins in the following month the well becomes a permanent establishment as of that date.

The twelve-month test applies separately to each 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 by a contractor 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 as a single project even if each house were constructed for a different purchaser.

In applying this paragraph, time spent by a sub-contractor on a building site is counted as time spent by the general contractor at the site for purposes of determining whether the general contractor has a permanent establishment. However, for the sub-contractor itself to be treated as having a permanent establishment, the sub-contractor's activities at the site must last for more than 12 months. If a sub-contractor is on a site intermittently, then, for purposes of applying the 12-month rule, time is measured from the first day the sub-contractor is on the site until the last day (*i.e.*, intervening days that the sub-contractor is not on the site are counted).

These interpretations of the Article are based on the Commentary to paragraph 3 of Article 5 of the OECD Model, which contains language that is substantially the same as that in the Convention. These interpretations are consistent with the generally accepted international interpretation of the relevant language in paragraph 3 of Article 5 of the Convention.

If the twelve-month threshold is exceeded, the site or project constitutes a permanent establishment from the first day of activity.

Paragraph 4

This paragraph contains exceptions to the general rule of paragraph 1, listing a number of activities that may be carried on through a fixed place of business but which nevertheless do not create a permanent establishment. The use of facilities solely to store, display or deliver merchandise belonging to an enterprise does 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 does not give rise to a permanent establishment of the first-mentioned enterprise. The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or for collecting information, for the enterprise, or for other activities that have a preparatory or auxiliary character for the enterprise, such as advertising, or the supply of information, do not constitute a permanent establishment of the enterprise. Moreover, subparagraph 4(f) provides that a combination of the activities described in the other subparagraphs of paragraph 4 will not give rise to a permanent establishment if the combination results in an overall activity that is of a preparatory or auxiliary character.

Paragraph 5

Paragraphs 5 and 6 specify when activities carried on by an agent or other person acting on behalf of an enterprise create a permanent establishment of that enterprise. Under paragraph 5, a person is deemed to create a permanent establishment of the enterprise if that person has and habitually exercises an authority to conclude contracts in the name of the enterprise. If, however, for example, his 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 person does not create a permanent establishment of the enterprise.

The Convention adopts the OECD Model language "in the name of the enterprise " rather than the U.S. Model language "binding on the enterprise." This difference in language is not intended to be a substantive difference. As indicated in paragraph 32 to the OECD Commentaries on Article 5, paragraph 5 is intended to encompass persons who have "sufficient authority to bind the enterprise's participation in the business activity in the State concerned."

The contracts referred to in paragraph 5 are those relating to the essential business operations of the enterprise, rather than ancillary activities. For example, if the person has no authority to conclude contracts in the name of the enterprise with its customers for, say, the sale of the goods produced by the enterprise, but it can enter into service contracts in the name of the enterprise for the enterprise's business equipment, this contracting authority would not fall within the scope of the paragraph, even if exercised regularly.

Paragraph 6

Under paragraph 6, an enterprise is not deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through an independent agent, including a broker or general commission agent, if the agent is acting in the ordinary course of his business as an independent agent. Thus, there are two conditions that must be satisfied: the agent must be both legally and economically independent of the enterprise, and the agent must be acting in the ordinary course of its business in carrying out activities on behalf of the enterprise.

Whether the agent and the enterprise are independent is a factual determination. Among the questions to be considered are the extent to which the agent operates on the basis of instructions from the enterprise. An agent that is subject to detailed instructions regarding the conduct of its operations or comprehensive control by the enterprise is not legally independent.

In determining whether the agent is economically independent, a relevant factor is the extent to which the agent bears business risk. Business risk refers primarily to risk of loss. An

independent agent typically bears risk of loss from its own activities. In the absence of other factors that would establish dependence, an agent that shares business risk with the enterprise, or has its own business risk, is economically independent because its business activities are not integrated with those of the principal. Conversely, an agent that bears little or no risk from the activities it performs is not economically independent and therefore is not described in paragraph 6.

Another relevant factor in determining whether an agent is economically independent is whether the agent acts exclusively or nearly exclusively for the principal. Such a relationship may indicate that the principal has economic control over the agent. A number of principals acting in concert also may have economic control over an agent. The limited scope of the agent's activities and the agent's dependence on a single source of income may indicate that the agent lacks economic independence. It should be borne in mind, however, that exclusivity is not in itself a conclusive test; an agent may be economically independent notwithstanding an exclusive relationship with the principal if it has the capacity to diversify and acquire other clients without substantial modifications to its current business and without substantial harm to its business profits. Thus, exclusivity should be viewed merely as a pointer to further investigation of the relationship between the principal and the agent. Each case must be addressed on the basis of its own facts and circumstances.

Paragraph 7

This paragraph clarifies that a company that is a resident of a Contracting State is not 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 is 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 IMMOVABLE PROPERTY (REAL PROPERTY))

This Article deals with the taxation of income from immovable property (real property) situated in a Contracting State (the "situs State"). The Article does not grant an exclusive taxing right to the situs State; the situs State is merely given the primary right to tax. The Article does not impose any limitation in terms of rate or form of tax imposed by the situs State.

Paragraph 1

The first paragraph of Article 6 states the general rule 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. The paragraph specifies that income from real property includes income from agriculture and forestry.

Paragraph 2

The term "real property" is defined in paragraph 2 by reference to the internal law definition in the situs State. In the case of the United States, the term has the meaning given to it by Reg. § 1.897-1(b). In addition to the statutory definitions in the two Contracting States, the paragraph specifies certain additional classes of property that, regardless of internal law

definitions, are within the scope of the term for purposes of the Convention. This expanded definition conforms to that in the OECD Model. The definition of "real property" for purposes of Article 6 is more limited than the expansive definition of "real property" in paragraph 1 of Article 13 (Capital Gains). The Article 13 term includes not only real property as defined in Article 6 but certain other interests in real property.

Paragraph 3

Paragraph 3 makes clear that all forms of income derived from the exploitation of real property are taxable in the Contracting State in which the property is situated. This includes income from any use of real property, including, but not limited to, income from direct use by the owner (in which case income may be imputed to the owner for tax purposes) and rental income from the letting of real property. In the case of a net lease of real property, if any elections to be taxed on a net basis as may be provided under the laws of the situs State have not been made, the gross rental payment (before deductible expenses incurred by the lessee) is treated as income from the property.

Other income closely associated with real property is covered by other Articles of the Convention, however, and not Article 6. For example, income from the disposition of an interest in real property is not considered "derived" from real property; taxation of that income is addressed in Article 13. Interest paid on a mortgage on real property would be covered by Article 11 (Interest). Distributions by a U.S. Real Estate Investment Trust or certain regulated investment companies would fall under Article 13 in the case of distributions of U.S. real property gain or Article 10 (Dividends) in the case of distributions treated as dividends. Finally, distributions from a United States Real Property Holding Corporation are not considered to be income from the exploitation of real property; such payments would fall under Article 10 or 13.

Paragraph 4

This paragraph specifies that the basic rule of paragraph 1 (as elaborated in paragraph 3) applies to income from real property of an enterprise. This clarifies that the situs country may tax the real property income (including rental income) of a resident of the other Contracting State in the absence of attribution to a permanent establishment in the situs State. This provision represents an exception to the general rule under Articles 7 (Business Profits) that income must be attributable to a permanent establishment in order to be taxable in the situs State.

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

Paragraph 1 states 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 business in that other Contracting State through a permanent establishment (as defined in Article 5 (Permanent Establishment)) situated there. When that condition is met, the State in which the permanent establishment is situated may tax the enterprise on the income that is attributable to the permanent establishment.

Although the Convention does not include a definition of "business profits," the term is intended to cover income derived from any trade or business. In accordance with this broad definition, the term "business profits" includes income attributable to notional principal contracts and other financial instruments to the extent that the income is attributable to a trade or business of dealing in such instruments or is otherwise related to a trade or business (as in the case of a notional principal contract entered into for the purpose of hedging currency risk arising from an active trade or business). Any other income derived from such instruments is, unless specifically covered in another article, dealt with under Article 20 (Other Income).

The term "business profits" also includes income derived by an enterprise from the rental of tangible personal property (unless such tangible personal property consists of aircraft, ships or containers, income from which is addressed by Article 8 (Shipping and Air Transport)). The inclusion of income derived by an enterprise from the rental of tangible personal property in business profits means that such income earned by a resident of a Contracting State can be taxed by the other Contracting State only if the income is attributable to a permanent establishment maintained by the resident in that other State, and, if the income is taxable, it can be taxed only on a net basis. Income from the rental of tangible personal property that is not derived in connection with a trade or business is dealt with in Article 20.

In addition, as a result of the definitions of "enterprise" and "business" in Article 3 (General Definitions), the term includes income derived from the furnishing of personal services. Thus, a consulting firm resident in one State whose employees or partners perform services in the other State through a permanent establishment may be taxed in that other State on a net basis under Article 7, and not under Article 14 (Income from Employment), which applies only to income of employees. With respect to the enterprise's employees themselves, however, their salary remains subject to Article 14.

Because this Article applies to income earned by an enterprise from the furnishing of personal services, the Article also applies to income derived by a partner resident in a Contracting State that is attributable to personal services performed in the other Contracting State through a partnership with a permanent establishment in that other State. Income which may be taxed under this Article includes all income attributable to the permanent establishment in respect of the performance of the personal services carried on by the partnership (whether by the partner himself, other partners in the partnership, or by employees assisting the partners) and any income from activities ancillary to the performance of those services (*e.g.*, charges for facsimile services).

The application of Article 7 to a service partnership may be illustrated by the following example: a partnership has five partners (who agree to split profits equally), four of whom are resident and perform personal services only in Iceland at Office A, and one of whom performs personal services at Office B, a permanent establishment in the United States. In this case, the four partners of the partnership resident in Iceland may be taxed in the United States in respect of their share of the income attributable to the permanent establishment, Office B. The services giving rise to income which may be attributed to the permanent establishment would include not only the services performed by the one resident partner, but also, for example, if one of the four other partners came to the United States and worked on an Office B matter there, the income in respect of those services. Income from the services performed by the visiting partner would be subject to tax in the United States regardless of whether the visiting partner actually visited or used Office B while performing services in the United States.

Paragraph 2

Paragraph 2 provides rules for the attribution of business profits to a permanent establishment. The Contracting States will attribute to a permanent establishment the profits that it would have earned had it been a distinct and separate 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.

The "attributable to" concept of paragraph 2 provides an alternative to the analogous but somewhat different "effectively connected" concept in Code section 864(c). Depending on the circumstances, the amount of income "attributable to" a permanent establishment under Article 7 may be greater or less than the amount of income that would be treated as "effectively connected" to a U.S. trade or business under Code section 864. In particular, in the case of financial institutions, the use of internal dealings to allocate income within an enterprise may produce results under Article 7 that are significantly different than the results under the effectively connected income rules. For example, income from interbranch notional principal contracts may be taken into account under Article 7, notwithstanding that such transactions may be ignored for purposes of U.S. domestic law.

The profits attributable to a permanent establishment may be from sources within or without a Contracting State. However, the business profits attributable to a permanent establishment include only those profits derived from the assets used, risks assumed, and activities performed by the permanent establishment.

Paragraph 2 of the Protocol confirms that the arm's length method of paragraphs 2 and 3 consists of applying the OECD Transfer Pricing Guidelines, but taking into account the different economic and legal circumstances of a single legal entity (as opposed to separate but associated enterprises). Thus, any of the methods used in the Transfer Pricing Guidelines, including profits methods, may be used as appropriate and in accordance with the Transfer Pricing Guidelines. However, the use of the Transfer Pricing Guidelines applies only for purposes of attributing profits within the legal entity. It does not create legal obligations or other tax consequences that would result from transactions having independent legal significance.

One example of the different circumstances of a single legal entity is that an entity that operates through branches rather than separate subsidiaries generally will have lower capital requirements because all of the assets of the entity are available to support all of the entity's liabilities (with some exceptions attributable to local regulatory restrictions). This is the reason that most commercial banks and some insurance companies operate through branches rather than subsidiaries. The benefit that comes from such lower capital costs must be allocated among the branches in an appropriate manner. This issue does not arise in the case of an enterprise that operates through separate entities, since each entity will have to be separately capitalized or will have to compensate another entity for providing capital (usually through a guarantee).

Under U.S. domestic regulations, internal "transactions" generally are not recognized because they do not have legal significance. In contrast, the Convention provides that such internal dealings may be used to attribute income to a permanent establishment in cases where the dealings accurately reflect the allocation of risk within the enterprise. One example is that of global trading in securities. In many cases, banks use internal swap transactions to transfer risk from one branch to a central location where traders have the expertise to manage that particular type of risk. Under the Convention, such a bank may also use such swap transactions as a means

of attributing income between the branches, if use of that method is the "best method" within the meaning of regulation section 1.482-1(c). The books of a branch will not be respected, however, when the results are inconsistent with a functional analysis. So, for example, income from a transaction that is booked in a particular branch (or home office) will not be treated as attributable to that location if the sales and risk management functions that generate the income are performed in another location.

Because the use of profits methods is permissible under paragraph 2, it is not necessary for the Convention to include a provision corresponding to paragraph 4 of Article 7 of the OECD Model.

Paragraph 3

Paragraph 3 provides that in determining the business profits of a permanent establishment, deductions shall be allowed for the expenses incurred for the purposes of the permanent establishment, ensuring that business profits will be taxed on a net basis. This rule is not limited to expenses incurred exclusively for the purposes of the permanent establishment, but includes expenses incurred for the purposes of the enterprise as a whole, or that part of the enterprise that includes the permanent establishment. Deductions are to be allowed regardless of which accounting unit of the enterprise books the expenses, so long as they are incurred for the purposes of the permanent establishment. For example, a portion of the interest expense recorded on the books of the home office in one State may be deducted by a permanent establishment in the other. The amount of the expense that must be allowed as a deduction is determined by applying the arm's length principle. And, as noted above with respect to paragraph 2 of Article 1 (General Scope), if a deduction would be allowed under the Code in computing the U.S. taxable income, the deduction also is allowed in computing taxable income under the Convention. However, except where the Convention provides for more favorable treatment, a taxpayer cannot take deductions for expenses in computing taxable income under the Convention to a greater extent than would be allowed under the Code where doing so would be inconsistent with the intent of the Code. For example, assume that a Bulgarian taxpayer with a permanent establishment in the United States borrows $100 to purchase U.S. tax exempt bonds, and that the $100 of tax-exempt bonds and the $100 of related debt would be treated as assets and liabilities of the permanent establishment. For purposes of computing the profits attributable to the permanent establishment under the Convention, both the tax exempt interest from the bonds and the interest expense from the related debt would be excluded.

As noted above, paragraph the Convention provides that the OECD Transfer Pricing Guidelines apply, by analogy, in determining the profits attributable to a permanent establishment. Accordingly, a permanent establishment may deduct payments made to its head office or another branch in compensation for services performed for the benefit of the branch. The method to be used in calculating that amount will depend on the terms of the arrangements between the branches and head office. For example, the enterprise could have a policy, expressed in writing, under which each business unit could use the services of lawyers employed by the head office. At the end of each year, the costs of employing the lawyers would be charged to each business unit according to the amount of services used by that business unit during the year. Since this appears to be a kind of cost-sharing arrangement and the allocation of costs is based on the benefits received by each business unit, such a cost allocation would be an acceptable means of determining a permanent establishment's deduction for legal expenses. Alternatively, the head office could agree to employ lawyers at its own risk, and to charge an arm's length price for legal services performed for a particular business unit. If the lawyers were under-utilized, and the "fees" received from the business units were less than the cost of employing the lawyers, then the head office would bear the excess cost. If the "fees" exceeded

the cost of employing the lawyers, then the head office would keep the excess to compensate it for assuming the risk of employing the lawyers. If the enterprise acted in accordance with this agreement, this method would be an acceptable alternative method for calculating a permanent establishment's deduction for legal expenses.

A permanent establishment cannot be funded entirely with debt, but must have sufficient capital to carry on its activities as if it were a distinct and separate enterprise. To the extent that the permanent establishment has not been attributed capital for profit attribution purposes, a Contracting State may attribute such capital to the permanent establishment, in accordance with the arm's length principle, and deny an interest deduction to the extent necessary to reflect that capital attribution. The method prescribed by U.S. domestic law for making this attribution is found in Treas. Reg. section 1.882-5. Both section 1.882-5 and the method prescribed the Convention start from the premise that all of the capital of the enterprise supports all of the assets and risks of the enterprise, and therefore the entire capital of the enterprise must be allocated to its various businesses and offices.

However, section 1.882-5 does not take into account the fact that some assets create more risk for the enterprise than do other assets. An independent enterprise would need less capital to support a perfectly-hedged U.S. Treasury security than it would need to support an equity security or other asset with significant market and/or credit risk. Accordingly, in some cases section 1.882-5 would require a taxpayer to allocate more capital to the United States, and therefore would reduce the taxpayer's interest deduction more, than is appropriate. To address these cases, the Convention allows a taxpayer to apply a more flexible approach that takes into account the relative risk of its assets in the various jurisdictions in which it does business. In particular, in the case of financial institutions other than insurance companies, the amount of capital attributable to a permanent establishment is determined by allocating the institution's total equity between its various offices on the basis of the proportion of the financial institution's risk-weighted assets attributable to each of them. This recognizes the fact that financial institutions are in many cases required to risk-weight their assets for regulatory purposes and, in other cases, will do so for business reasons even if not required to do so by regulators. However, risk-weighting is more complicated than the method prescribed by section 1.882-5. Accordingly, to ease this administrative burden, taxpayers may choose to apply the principles of Treas. Reg. section 1.882-5(c) to determine the amount of capital allocable to its U.S. permanent establishment, in lieu of determining its allocable capital under the risk-weighted capital allocation method provided by the Convention, even if it has otherwise chosen the principles of Article 7 rather than the effectively connected income rules of U.S. domestic law.

Paragraph 4

Paragraph 4 provides that no business profits can be attributed to a permanent establishment merely because it purchases goods or merchandise for the enterprise of which it is a part. This paragraph is essentially identical to paragraph 5 of Article 7 of the OECD Model. This rule applies only to an office that performs functions for the enterprise in addition to purchasing. The income attribution issue does not arise if the sole activity of the office is the purchase of goods or merchandise because such activity does not give rise to a permanent establishment under Article 5 (Permanent Establishment). A common situation in which paragraph 4 is relevant is one in which a permanent establishment purchases raw materials for the enterprise's manufacturing operation conducted outside the United States and sells the manufactured product. 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.

Paragraph 5

Paragraph 5 provides that profits shall be determined by the same method each year, unless there is good reason to change the method used. This rule assures consistent tax treatment over time for permanent establishments. It limits the ability of both the Contracting State and the enterprise to change accounting methods to be applied to the permanent establishment. It does not, however, restrict a Contracting State from imposing additional requirements, such as the rules under Code section 481, to prevent amounts from being duplicated or omitted following a change in accounting method. Such adjustments may be necessary, for example, if the taxpayer switches from using the domestic rules under section 864 in one year to using the rules of Article 7 in the next. Also, if the taxpayer switches from Convention-based rules to U.S. domestic rules, it may need to meet certain deadlines for making elections that are not necessary when applying the rules of the Convention.

Paragraph 6

Paragraph 6 coordinates the provisions of Article 7 and other provisions of the Convention. Under this paragraph, when business profits include items of income that are dealt with separately under other articles of the Convention, the provisions of those articles will, except when they specifically provide to the contrary, take precedence over the provisions of Article 7. For example, the taxation of dividends will be determined by the rules of Article 10 (Dividends), and not by Article 7, except where, as provided in paragraph 6 of Article 10, the dividend is attributable to a permanent establishment. In the latter case the provisions of Article 7 apply. Thus, an enterprise of one State deriving dividends from the other State may not rely on Article 7 to exempt those dividends from tax at source if they are not attributable to a permanent establishment of the enterprise in the other State. By the same token, if the dividends are attributable to a permanent establishment in the other State, the dividends may be taxed on a net income basis at the source State full corporate tax rate, rather than on a gross basis under Article 10.

As provided in Article 8 (Shipping and Air Transport), income derived from shipping and air transport activities in international traffic described in that Article is taxable only in the country of residence of the enterprise regardless of whether it is attributable to a permanent establishment situated in the source State.

Paragraph 7

Paragraph 7 incorporates into the Convention the rule of Code section 864(c)(6). Like the Code section on which it is based, paragraph 7 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 situated, even if the payment of that income or gain is deferred until after the permanent establishment ceases to exist. This rule applies with respect to paragraphs 1 and 2 of Article 7 (Business Profits), paragraph 6 of Article 10, paragraph 4 of Article 11 (Interest), paragraph 3 of Articles 12 (Royalties) and 13 (Capital Gains) and paragraph 2 of Article 20 (Other Income).

The effect of this rule can be illustrated by the following example. Assume a company that is a resident of Iceland and that maintains a permanent establishment in the United States winds up the permanent establishment's business and sells the permanent establishment's inventory and assets to a U.S. buyer at the end of year 1 in exchange for an interest-bearing installment obligation payable in full at the end of year 3. Despite the fact that Article 13's

threshold requirement for U.S. taxation is not met in year 3 because the company has no permanent establishment in the United States, the United States may tax the deferred income payment recognized by the company in year 3.

Relationship to Other Articles

This Article is subject to the saving clause of paragraph 4 of Article 1 (General Scope) of the Model. Thus, if a citizen of the United States who is a resident of Iceland under the treaty 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 4 of Article 22 (Relief from Double Taxation), tax those profits, notwithstanding the provision of paragraph 1 of this Article which would exempt the income from U.S. tax.

The benefits of this Article are also subject to Article 21 (Limitation on Benefits). Thus, an enterprise of Iceland that derives income effectively connected with a U.S. trade or business may not claim the benefits of Article 7 unless the resident carrying on the enterprise qualifies for such benefits under Article 21.

As provided in paragraph 3 of the Protocol, Articles 7 and 23 (Non-Discrimination) shall not prevent Iceland from continuing to tax permanent establishments of United States insurance companies in accordance with Article 70, paragraph 2, section 3 of the Icelandic Tax Code, nor shall it prevent the United States from continuing to tax permanent establishments of Icelandic insurance companies in accordance with section 842 b) of the Code.

ARTICLE 8 (SHIPPING AND AIR TRANSPORT)

This Article governs the taxation of profits from the operation of ships and aircraft in international traffic. The term "international traffic" is defined in subparagraph 1(h) of Article 3 (General Definitions).

Paragraph 1

Paragraph 1 provides that profits derived by an enterprise of a Contracting State from the operation in international traffic of ships or aircraft are taxable only in that Contracting State. Because paragraph 6 of Article 7 (Business Profits) defers to Article 8 with respect to shipping income, such income derived by a resident of one of the Contracting States may not be taxed in the other State even if the enterprise has a permanent establishment in that other State. Thus, if a U.S. airline has a ticket office in Iceland, Iceland may not tax the airline's profits attributable to that office under Article 7. Since entities engaged in international transportation activities normally will have many permanent establishments in a number of countries, the rule avoids difficulties that would be encountered in attributing income to multiple permanent establishments if the income were covered by Article 7.

Paragraph 2

The income from the operation of ships or aircraft in international traffic that is exempt from tax under paragraph 1 is defined in paragraph 2.

In addition to income derived directly from the operation of ships and aircraft in international traffic, this definition also includes certain items of rental income. First, income of

an enterprise of a Contracting State from the rental of ships or aircraft on a full basis (i.e., with crew) is income of the lessor from the operation of ships and aircraft in international traffic and, therefore, is exempt from tax in the other Contracting State under paragraph 1. Also, paragraph 2 encompasses income from the lease of ships or aircraft on a bareboat basis (i.e., without crew), either when the income is incidental to other income of the lessor from the operation of ships or aircraft in international traffic, or when the ships or aircraft are operated in international traffic by the lessee. If neither of those two conditions apply, income from the bareboat rentals would constitute business profits. The coverage of Article 8 is therefore broader than that of Article 8 of the OECD Model, which covers bareboat leasing only when it is incidental to other income of the lessor from the operation of ships of aircraft in international traffic.

Paragraph 2 also clarifies, consistent with the Commentary to Article 8 of the OECD Model, that income earned by an enterprise from the inland transport of property or passengers within either Contracting State falls within Article 8 if the transport is undertaken as part of the international transport of property or passengers by the enterprise. Thus, if a U.S. shipping company contracts to carry property from Iceland to a U.S. city and, as part of that contract, it transports the property by truck from its point of origin to an airport in Iceland (or it contracts with a trucking company to carry the property to the airport) the income earned by the U.S. shipping company from the overland leg of the journey would be taxable only in the United States. Similarly, Article 8 also would apply to all of the income derived from a contract for the international transport of goods, even if the goods were transported to the port by a lighter, not by the vessel that carried the goods in international waters.

Finally, certain non-transport activities that are an integral part of the services performed by a transport company, or are ancillary to the enterprise's operation of ships or aircraft in international traffic, are understood to be covered in paragraph 1, though they are not specified in paragraph 2. These include, for example, the provision of goods and services by engineers, ground and equipment maintenance and staff, cargo handlers, catering staff and customer services personnel. Where the enterprise provides such goods to, or performs services for, other enterprises and such activities are directly connected with or ancillary to the enterprise's operation of ships or aircraft in international traffic, the profits from the provision of such goods and services to other enterprises will fall under this paragraph.

For example, enterprises engaged in the operation of ships or aircraft in international traffic may enter into pooling arrangements for the purposes of reducing the costs of maintaining facilities needed for the operation of their ships or aircraft in other countries. For instance, where an airline enterprise agrees (for example, under an International Airlines Technical Pool agreement) to provide spare parts or maintenance services to other airlines landing at a particular location (which allows it to benefit from these services at other locations), activities carried on pursuant to that agreement will be ancillary to the operation of aircraft in international traffic by the enterprise.

Also, advertising that the enterprise may do for other enterprises in magazines offered aboard ships or aircraft that it operates in international traffic or at its business locations, such as ticket offices, is ancillary to its operation of these ships or aircraft. Profits generated by such advertising fall within this paragraph. Income earned by concessionaires, however, is not covered by Article 8. These interpretations of paragraph 1 also are consistent with the Commentary to Article 8 of the OECD Model.

Paragraph 3

Under this paragraph, profits of an enterprise of a Contracting State from the use, maintenance or rental of containers (including equipment for their transport) used in international traffic are exempt from tax in the other Contracting State. This result obtains under paragraph 3 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. Only income from the use, maintenance or rental of containers that is incidental to other income from international traffic is covered by Article 8 of the OECD Model.

Paragraph 4

This paragraph clarifies that the provisions of paragraphs 1 and 3 also apply to profits derived by an enterprise of a Contracting State 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, airlines from two countries may agree to share the transport of passengers between the two countries. They each will fly the same number of flights per week and share the revenues from that route equally, regardless of the number of passengers that each airline actually transports. Paragraph 4 makes clear that with respect to each carrier the income dealt with in the Article is that carrier's share of the total transport, not the income derived from the passengers actually carried by the airline. This paragraph corresponds to paragraph 4 of Article 8 of the OECD Model.

Relationship to Other Articles

The taxation of gains from the alienation of ships, aircraft or containers is not dealt with in this Article but in paragraph 4 of Article 13 (Capital Gains).

As with other benefits of the Convention, the benefit of exclusive residence country taxation under Article 8 is available to an enterprise only if it is entitled to benefits under Article 21 (Limitation on Benefits).

This Article also is subject to the saving clause of paragraph 4 of Article 1 (General Scope) of the Model. Thus, if a citizen of the United States who is a resident of Iceland derives profits from the operation of ships or aircraft in international traffic, notwithstanding the exclusive residence country taxation in paragraph 1 of Article 8, the United States may, subject to the special foreign tax credit rules of paragraph 4 of Article 22 (Relief from Double Taxation), tax those profits as part of the worldwide income of the citizen. (This is an unlikely situation, however, because non-tax considerations (e.g., insurance) generally result in shipping activities being carried on in corporate form.)

ARTICLE 9 (ASSOCIATED ENTERPRISES)

This Article incorporates in the Convention the arm's-length principle reflected in the U.S. domestic transfer pricing provisions, particularly Code section 482. It provides that when related enterprises engage in a transaction on terms that are not arm's-length, the Contracting States may make appropriate adjustments to the taxable income and tax liability of such related enterprises to reflect what the income and tax of these enterprises with respect to the transaction would have been had there been an arm's-length relationship between them.

Paragraph 1

This paragraph is essentially the same as its counterpart in the U.S. and OECD Models. It addresses the situation where an enterprise of a Contracting State is related to an enterprise of the other Contracting State, and there are arrangements or conditions imposed between the enterprises in their commercial or financial relations that are different from those that would have existed in the absence of the relationship. Under these circumstances, the Contracting States may adjust the income (or loss) of the enterprise to reflect what it would have been in the absence of such a relationship.

The paragraph identifies the relationships between enterprises that serve as a prerequisite to application of the Article. As the Commentary to the OECD Model makes clear, the necessary element in these relationships is effective control, which is also the standard for purposes of section 482. Thus, the Article applies if an enterprise of one State participates directly or indirectly in the management, control, or capital of the enterprise of the other State. Also, the Article applies if any third person or persons participate directly or indirectly in the management, control, or capital of enterprises of different States. For this purpose, all types of control are included, i.e., whether or not legally enforceable and however exercised or exercisable.

The fact that a transaction is entered into between such related enterprises does not, in and of itself, mean that a Contracting State may adjust the income (or loss) of one or both of the enterprises under the provisions of this Article. If the conditions of the transaction are consistent with those that would be made between independent persons, the income arising from that transaction should not be subject to adjustment under this Article.

Similarly, the fact that associated enterprises may have concluded arrangements, such as cost sharing arrangements or general services agreements, is not in itself an indication that the two enterprises have entered into a non-arm's-length transaction that should give rise to an adjustment under paragraph 1. Both related and unrelated parties enter into such arrangements (e.g., joint venturers may share some development costs). As with any other kind of transaction, when related parties enter into an arrangement, the specific arrangement must be examined to see whether or not it meets the arm's-length standard. In the event that it does not, an appropriate adjustment may be made, which may include modifying the terms of the agreement or re-characterizing the transaction to reflect its substance.

It is understood that the "commensurate with income" standard for determining appropriate transfer prices for intangibles, added to Code section 482 by the Tax Reform Act of 1986, was designed to operate consistently with the arm's-length standard. The implementation of this standard in the section 482 regulations is in accordance with the general principles of paragraph 1 of Article 9 of the Convention, as interpreted by the OECD Transfer Pricing Guidelines.

This Article also permits tax authorities to deal with thin capitalization issues. They may, in the context of Article 9, scrutinize more than the rate of interest charged on a loan between related persons. They also may examine the capital structure of an enterprise, whether a payment in respect of that loan should be treated as interest, and, if it is treated as interest, under what circumstances interest deductions should be allowed to the payor. Paragraph 2 of the Commentary to Article 9 of the OECD Model, together with the U.S. observation set forth in paragraph 15, sets forth a similar understanding of the scope of Article 9 in the context of thin capitalization.

Paragraph 2

When 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 to reflect arm's-length conditions, that other Contracting State is obligated to make a correlative adjustment (sometimes referred to as a "corresponding adjustment") to the tax liability of the related person in that other Contracting State. Although the OECD Model does not specify that the other Contracting State must agree with the initial adjustment before it is obligated to make the correlative adjustment, the Commentary makes clear that the paragraph is to be read that way.

As explained in the Commentary to Article 9 of the OECD Model, Article 9 leaves the treatment of "secondary adjustments" to the laws of the Contracting States. When an adjustment under Article 9 has been made, one of the parties will have in its possession funds that it would not have had at arm's length. The question arises as to how to treat these funds. In the United States the general practice is to treat such funds as a dividend or contribution to capital, depending on the relationship between the parties. Under certain circumstances, the parties may be permitted to restore the funds to the party that would have the funds had the transactions been entered into on arm's length terms, and to establish an account payable pending restoration of the funds. See Rev. Proc. 99-32, 1999-2 C.B. 296.

The Contracting State making a secondary adjustment will take the other provisions of the Convention, where relevant, into account. For example, if the effect of a secondary adjustment is to treat a U.S. corporation as having made a distribution of profits to its parent corporation in the other Contracting State, the provisions of Article 10 (Dividends) will apply, and the United States may impose a 5 percent withholding tax on the dividend. Also, if under Article 22 (Relief from Double Taxation) the other State generally gives a credit for taxes paid with respect to such dividends, it would also be required to do so in this case.

The competent authorities are authorized by paragraph 3 of Article 24 (Mutual Agreement Procedure) 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.

If a correlative adjustment is made under paragraph 2, it is to be implemented, pursuant to paragraph 2 of Article 24, notwithstanding any time limits or other procedural limitations in the law of the Contracting State making the adjustment. If a taxpayer has entered a closing agreement (or other written settlement) with the United States prior to bringing a case to the competent authorities, the U.S. competent authority will endeavor only to obtain a correlative adjustment from Iceland. See, Rev. Proc. 2006-54, 2006-49 I.R.B.1035, Section 7.05.

Relationship to Other Articles

The saving clause of paragraph 4 of Article 1 (General Scope) does not apply to paragraph 2 of Article 9 by virtue of an exception to the saving clause in subparagraph 5(a) of Article 1. Thus, even if the statute of limitations has run, a refund of tax can be made in order to implement a correlative adjustment. Statutory or procedural limitations, however, cannot be overridden to impose additional tax, because paragraph 2 of Article 1 provides that the Convention cannot restrict any statutory benefit.

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 beneficial owner that is a resident of the other Contracting State. The Article provides for full residence State taxation of such dividends and a limited source-State right to tax. Article 10 also provides rules for the imposition of a tax on branch profits by the State of source. Finally, the article prohibits a State from imposing taxes on a company resident in the other Contracting State, other than a branch profits tax, on undistributed earnings.

Paragraph 1

The right of a shareholder's country of residence to tax dividends arising in the source country is preserved by paragraph 1, which permits a Contracting State to tax its residents on dividends paid to them by a company that is a resident of the other Contracting State. For dividends from any other source paid to a resident, Article 20 (Other Income) grants the residence country exclusive taxing jurisdiction (other than for dividends attributable to a permanent establishment in the other State).

Paragraph 2

The State of source also may tax dividends beneficially owned by a resident of the other State, subject to the limitations of paragraphs 2 and 3. Paragraph 2 generally limits the rate of withholding tax in the State of source on dividends paid by a company resident in that State to 15 percent of the gross amount of the dividend. If, however, the beneficial owner of the dividend is a company resident in the other State and owns directly shares representing at least 10 percent of the share capital, as represented as voting power of the company paying the dividend, then the rate of withholding tax in the State of source is limited to 5 percent of the gross amount of the dividend. Shares are considered voting shares if they provide the power to elect, appoint or replace any person vested with the powers ordinarily exercised by the board of directors of a U.S. corporation.

The benefits of paragraph 2 may be granted at the time of payment by means of reduced rate of withholding tax at source. It also is consistent with the paragraph for tax to be withheld at the time of payment at full statutory rates, and the treaty benefit to be granted by means of a subsequent refund so long as such procedures are applied in a reasonable manner.

The determination of whether the ownership threshold for subparagraph 2(a) is met for purposes of the 5 percent maximum rate of withholding tax is made on the date on which entitlement to the dividend is determined. Thus, in the case of a dividend from a U.S. company, the determination of whether the ownership threshold is met generally would be made on the dividend record date.

Paragraph 2 does not affect the taxation of the profits out of which the dividends are paid. The taxation by a Contracting State of the income of its resident companies is governed by the internal law of the Contracting State, subject to the provisions of paragraph 4 of Article 23 (Non-Discrimination).

The term "beneficial owner" 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 that is a resident of one of the States (as determined under Article 4 (Resident)) 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 a nominee on behalf of a resident of that other State would be entitled to benefits. These limitations are confirmed by paragraph 12 of the Commentary to Article 10 of the OECD Model.

Special rules, however, apply to shares that are held through fiscally transparent entities. In that case, the rules of paragraph 6 of Article 1 (General Scope) will apply to determine whether the dividends should be treated as having been derived by a resident of a Contracting State. Residence State principles shall be used to determine who derives the dividend, to assure that the dividends for which the source State grants benefits of the Convention will be taken into account for tax purposes by a resident of the residence State. Source State principles of beneficial ownership shall then apply to determine whether the person who derives the dividends, or another resident of the other Contracting State, is the beneficial owner of the dividend. The source State may conclude that the person who derives the dividend in the residence State is a mere nominee, agent, conduit, etc., for a third country resident and deny benefits of the Convention. If the person who derives the dividend under paragraph 6 of Article 1 would not be treated under the source State's principles for determining beneficial ownership as a nominee, agent, custodian, conduit, etc., that person will be treated as the beneficial owner of the income, profits or gains for purposes of the Convention.

Assume, for instance, that a company resident in Iceland pays a dividend to LLC, an entity which is treated as fiscally transparent for U.S. tax purposes but is treated as a company for Icelandic tax purposes. USCo, a company incorporated in the United States, is the sole interest holder in LLC. Paragraph 6 of Article 1 provides that USCo derives the dividend. Iceland's principles of beneficial ownership shall then be applied to USCo. If under the laws of Iceland USCo is found not to be the beneficial owner of the dividend, USCo will not be entitled to the benefits of Article 10 with respect to such dividend. The payment may be entitled to benefits, however, if USCo is found to be a nominee, agent, custodian or conduit for a person who is a resident of the United States.

Beyond identifying the person to whom the principles of beneficial ownership shall be applied, the principles of paragraph 6 of Article 1 will also apply when determining whether other requirements, such as the ownership threshold of subparagraph 2(a) have been satisfied.

For example, assume that IceCo, a company that is a resident of Iceland, owns all of the outstanding shares in ThirdDE, an entity that is disregarded for U.S. tax purposes that is resident in a third country. ThirdDE owns 100% of the stock of USCo. Iceland views ThirdDE as fiscally transparent under its domestic law, and taxes IceCo currently on the income derived by ThirdDE. In this case, IceCo is treated as deriving the dividends paid by USCo under paragraph 6 of Article 1. Moreover, IceCo is treated as owning the shares of USCo directly. The Convention does not address what constitutes direct ownership for purposes of Article 10. As a result, whether ownership is direct is determined under the internal law of the country imposing tax (i.e., the source country) unless the context otherwise requires. Accordingly, a company that holds stock through such an entity will generally be considered to directly own such stock for purposes of Article 10.

This result may change, however, if ThirdDE is regarded as non-fiscally transparent under the laws of Iceland. Assuming that ThirdDE is treated as non-fiscally transparent by

Iceland, the income will not be treated as derived by a resident of Iceland for purposes of the Convention. However, ThirdDE may still be entitled to the benefits of the U.S. tax treaty, if any, with its country of residence.

The same principles would apply in determining whether companies holding shares through fiscally transparent entities such as partnerships, trusts, and estates would qualify for benefits. As a result, companies holding shares through such entities may be able to claim the benefits of subparagraph 2(a) under certain circumstances. The lower rate applies when the company's proportionate share of the shares held by the intermediate entity meets the 10 percent threshold, and the company meets the requirements of Article 1(6) (i.e., the company's country of residence treats the intermediate entity as fiscally transparent) with respect to the dividend. Whether this ownership threshold is satisfied may be difficult to determine and often will require an analysis of the partnership or trust agreement.

Paragraph 3

Paragraph 3 imposes limitations on the rate reductions provided by paragraphs 2 and 3 in the case of dividends paid by RIC or a REIT.

The first sentence of subparagraph 3(a) provides that dividends paid by a RIC or REIT are not eligible for the 5 percent rate of withholding tax of subparagraph 2(a).

The second sentence of subparagraph 3(a) provides that the 15 percent maximum rate of withholding tax of subparagraph 2(b) applies to dividends paid by RICs.

The third sentence of subparagraph 3(a) provides that the 15 percent rate of withholding tax also applies to dividends paid by a REIT provided that one of the three following conditions is met. First, the beneficial owner of the dividend is an individual or a pension fund, in either case holding an interest of not more than 10 percent in the REIT. Second, the dividend is paid with respect to a class of stock that is publicly traded and the beneficial owner of the dividend is a person holding an interest of not more than 5 percent of any class of the REIT's shares. Third, the beneficial owner of the dividend holds an interest in the REIT of not more than 10 percent and the REIT is "diversified." A REIT is diversified if the gross value of no single interest in real property held by the REIT exceeds 10 percent of the gross value of the REIT's total interest in real property. Foreclosure property is not considered an interest in real property, and a REIT holding a partnership interest is treated as owning its proportionate share of any interest in real property held by the partnership.

The restrictions set out above are intended to prevent the use of these entities to gain inappropriate U.S. tax benefits. For example, a company resident in Iceland that wishes to hold a diversified portfolio of U.S. corporate shares could hold the portfolio directly and would bear a U.S. withholding tax of 15 percent on all of the dividends that it receives. Alternatively, it could hold the same diversified portfolio by purchasing 10 percent or more of the interests in a RIC. If the RIC is a pure conduit, there may be no U.S. tax cost to interposing the RIC in the chain of ownership. Absent the special rule in paragraph 3, such use of the RIC could transform portfolio dividends, taxable in the United States under the Convention at a 15 percent maximum rate of withholding tax, into direct investment dividends taxable at a 5 percent maximum rate of withholding tax or eligible for the elimination of source-country withholding tax on dividends paid to pension funds as provided in paragraph 4.

Similarly, a resident of Iceland directly holding U.S. real property would pay U.S. tax upon the sale of the property either at a 30 percent rate of withholding tax on the gross income or at graduated rates on the net income. As in the preceding example, by placing the real property in a REIT, the investor could, absent a special rule, transform income from the sale of real estate into dividend income from the REIT, taxable at the rates provided in Article 10, significantly reducing the U.S. tax that otherwise would be imposed. Paragraph 3 prevents this result and thereby avoids a disparity between the taxation of direct real estate investments and real estate investments made through REIT conduits. In the cases in which paragraph 3 allows a dividend from a REIT to be eligible for the 15 percent rate of withholding tax, the holding in the REIT is not considered the equivalent of a direct holding in the underlying real property.

Paragraph 4

Paragraph 4 provides that dividends beneficially owned by a pension scheme or employee benefits organization may not be taxed in the Contracting State of which the company paying the tax is a resident. However, the exemption provided in paragraph 4 shall not apply if the dividends are derived from the carrying on of a business, directly or indirectly, by the pension scheme or employee benefits organization. For these purposes, the term "pension scheme" is defined in subparagraph 1(l) of Article 3 (General Definitions).

The exemption is provided because pension schemes and employee benefits organizations normally do not pay tax (either through a general exemption or because reserves for future pension liabilities effectively offset all of the fund's income), and therefore cannot benefit from a foreign tax credit. Moreover, distributions from a pension fund generally do not maintain the character of the underlying income, so the beneficiaries of the pension are not in a position to claim a foreign tax credit when they finally receive the pension, in many cases years after the withholding tax has been paid. Accordingly, in the absence of this rule, the dividends would almost certainly be subject to unrelieved double taxation.

Paragraph 5

Paragraph 5 defines the term dividends broadly and flexibly. The definition is intended to cover all arrangements that yield a return on an equity investment in a corporation as determined under the tax law of the state of source, as well as arrangements that might be developed in the future.

The term includes income from shares, or other corporate rights that are not treated as debt under the law of the source State, that participate in the profits of the company. The term also includes income that is subjected to the same tax treatment as income from shares by the law of the State of source. Thus, a constructive dividend that results from a non-arm's length transaction between a corporation and a related party is a dividend. In the case of the United States the term dividend includes amounts treated as a dividend under U.S. law upon the sale or redemption of shares or upon a transfer of shares in a reorganization. See, e.g., Rev. Rul. 92-85, 1992-2 C.B. 69 (sale of foreign subsidiary=s stock to U.S. sister company is a deemed dividend to extent of the subsidiary's and sister company's earnings and profits). Further, a distribution from a U.S. publicly traded limited partnership, which is taxed as a corporation under U.S. law, is a dividend for purposes of Article 10. However, a distribution by a limited liability company is not taxable by the United States under Article 10, provided the limited liability company is not characterized as an association taxable as a corporation under U.S. law.

Finally, a payment denominated as interest that is made by a thinly capitalized corporation may be treated as a dividend to the extent that the debt is recharacterized as equity under the laws of the source State.

Paragraph 6

Paragraph 6 provides a rule for taxing dividends paid with respect to holdings that form part of the business property of a permanent establishment. In such case, the rules of Article 7 (Business Profits) shall apply. Accordingly, the 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 is located, as such rules may be modified by the Convention. An example of dividends paid with respect to the business property of a permanent establishment would be dividends derived by a dealer in stock or securities from stock or securities that the dealer held for sale to customers.

Paragraph 7

The right of a Contracting State to tax dividends paid by a company that is a resident of the other Contracting State is restricted by paragraph 7 to cases in which the dividends are paid to a resident of that Contracting State or are attributable to a permanent establishment or fixed base in that Contracting State. Thus, a Contracting State may not impose a "secondary" withholding tax on dividends paid by a nonresident company out of earnings and profits from that Contracting State

The paragraph also restricts the right of a Contracting State to impose corporate level taxes on undistributed profits, other than a branch profits tax. The paragraph does not restrict a State's right to tax its resident shareholders on undistributed earnings of a corporation resident in the other State. Thus, the authority of the United States to impose taxes on subpart F income and on earnings deemed invested in U.S. property, and its tax on income of a passive foreign investment company that is a qualified electing fund is in no way restricted by this provision.

Paragraph 8

Paragraph 8 permits a Contracting State to impose a branch profits tax on a company resident in the other Contracting State. The tax is in addition to other taxes permitted by the Convention. The term "company" is defined in subparagraph 1(d) of Article 3 (General Definitions).

A Contracting State may impose a branch profits tax on a company if the company has income attributable to a permanent establishment in that Contracting State, derives income from real property in that Contracting State that is taxed on a net basis under Article 6 (Income from Immovable Property (Real Property)), or realizes gains taxable in that State under paragraph 1 of Article 13 (Capital Gains). In the case of the United States, the imposition of such tax is limited, however, to the portion of the aforementioned items of income that represents the amount of such income that is the "dividend equivalent amount." This is consistent with the relevant rules under the U.S. branch profits tax, and the term dividend equivalent amount is defined in paragraph 4 of the Protocol as that portion of the income mentioned in paragraph 7 of Article 10 that is comparable to the amount that would be distributed as a dividend if such income were earned by a subsidiary incorporated in the United States. For any year, a foreign corporation's dividend equivalent amount is equal to the after-tax earnings attributable to the foreign corporation's (i) income attributable to a permanent establishment in the United States, (ii)

income from real property in the United States that is taxed on a net basis under Article 6 (Income from Immovable Property (Real Property)), and (iii) gain from a real property interest taxable by the United States under paragraph 1 of Article 13 (Capital Gains), reduced by any increase in the foreign corporation's net investment in U.S. assets or increased by any reduction in the foreign corporation's net investment in U.S. assets.

The dividend equivalent amount for any year approximates the dividend that a U.S. branch office would have paid during the year if the branch had been operated as a separate U.S. subsidiary company. If Iceland also imposes a branch profits tax, the base of its tax must be limited to an amount that is analogous to the dividend equivalent amount.

As discussed in the Technical Explanations to Articles 1(2) and 7(2), consistency principles require that a taxpayer may not mix and match the rules of the Code and the Convention in an inconsistent manner. In the context of the branch profits tax, the consistency requirement means that an enterprise that uses the principles of Article 7 to determine its net taxable income also must use the principles in determining the dividend equivalent amount. Similarly, an enterprise that uses U.S. domestic law to determine its net taxable income must also use U.S. domestic law in complying with the branch profits tax. As in the case of Article 7, if an enterprise switches between domestic law and treaty principles from year to year, it will need to make appropriate adjustments or recapture amounts that otherwise might go untaxed.

Paragraph 9

Paragraph 9 provides that the branch profits tax shall not be imposed at a rate exceeding the direct investment dividend withholding rate of five percent.

Relationship to Other Articles

Notwithstanding the foregoing limitations on source country taxation of dividends, the saving clause of paragraph 4 of Article 1 permits the United States to tax dividends received by its residents and citizens, subject to the special foreign tax credit rules of paragraph 4 of Article 22 (Relief from Double Taxation), as if the Convention had not come into effect.

The benefits of this Article are also subject to the provisions of Article 21 (Limitation on Benefits). Thus, if a resident of the other Contracting State is the beneficial owner of dividends paid by a U.S. corporation, the shareholder must qualify for treaty benefits under at least one of the tests of Article 21 in order to receive the benefits of this Article.

ARTICLE 11 (INTEREST)

Article 11 specifies the taxing jurisdictions over interest income of the States of source and residence and defines the terms necessary to apply the Article.

Paragraph 1

Paragraph 1 generally grants to the State of residence the exclusive right to tax interest beneficially owned by its residents and arising in the other Contracting State.

The term "beneficial owner" is not defined in the Convention, and is, therefore, defined under the internal law of the State of source. The beneficial owner of the interest for purposes of

Article 11 is the person to which the income is attributable under the laws of the source State. Thus, if interest arising in a Contracting State 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 interest is not entitled to the benefits of Article 11. However, interest received by a nominee on behalf of a resident of that other State would be entitled to benefits. These limitations are confirmed by paragraph 9 of the OECD Commentary to Article 11.

Paragraph 2

The term "interest" as used in Article 11 is defined in paragraph 2 to include, *inter alia*, income from debt claims of every kind, whether or not secured by a mortgage. Penalty charges for late payment are excluded from the definition of interest. Interest that is paid or accrued subject to a contingency is within the ambit of Article 11. This includes income from a debt obligation carrying the right to participate in profits. The term does not, however, include amounts that are treated as dividends under Article 10 (Dividends).

The term interest also includes amounts subject to the same tax treatment as income from money lent under the law of the State in which the income arises. Thus, for purposes of the Convention, amounts that the United States will treat as interest include (i) the difference between the issue price and the stated redemption price at maturity of a debt instrument (*i.e.*, original issue discount ("OID")), which may be wholly or partially realized on the disposition of a debt instrument (section 1273), (ii) amounts that are imputed interest on a deferred sales contract (section 483), (iii) amounts treated as interest or OID under the stripped bond rules (section 1286), (iv) amounts treated as original issue discount under the below-market interest rate rules (section 7872), (v) a partner's distributive share of a partnership's interest income (section 702), (vi) the interest portion of periodic payments made under a "finance lease" or similar contractual arrangement that in substance is a borrowing by the nominal lessee to finance the acquisition of property, (vii) amounts included in the income of a holder of a residual interest in a REMIC (section 860E), because these amounts generally are subject to the same taxation treatment as interest under U.S. tax law, and (viii) interest with respect to notional principal contracts that are re-characterized as loans because of a "substantial non-periodic payment."

Paragraph 3

Paragraph 3 provides an exception to the exclusive residence taxation rule of paragraph 1 and the source-country gross taxation rule of paragraph 5 in cases where the beneficial owner of the interest carries on business through a permanent establishment in the State of source situated in that State and the interest is attributable to that permanent establishment. In such cases the provisions of Article 7 (Business Profits) will apply and the State of source will retain the right to impose tax on such interest income.

In the case of a permanent establishment that once existed in the State but that no longer exists, the provisions of paragraph 3 also apply, by virtue of paragraph 7 of Article 7, to interest that would be attributable to such a permanent establishment or fixed base if it did exist in the year of payment or accrual. See the Technical Explanation of paragraph 7 of Article 7.

Paragraph 4

Paragraph 4 provides that in cases involving special relationships between the payor and the beneficial owner of interest income, Article 11 applies only to that portion of the total 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 Iceland, respectively, with due regard to the other provisions of the Convention. Thus, if the excess amount would be treated under the source country's law as a distribution of profits by a corporation, 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.

The term "special relationship" is not defined in the Convention. In applying this paragraph the United States considers the term to include the relationships described in Article 9, which in turn corresponds to the definition of "control" for purposes of section 482 of the Code.

This paragraph does not address cases where, owing to a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest is less than an arm's-length amount. In those cases a transaction may be characterized to reflect its substance and interest may be imputed consistent with the definition of interest in paragraph 3. The United States would apply section 482 or 7872 of the Code to determine the amount of imputed interest in those cases.

Paragraph 5

Paragraph 5 provides anti-abuse exceptions to the source-country exemption in paragraph 1 for two classes of interest payments.

The first class of interest, dealt with in subparagraph 5(a) is so-called "contingent interest." Under this provision, interest arising in a Contracting State that is determined by reference to the receipts, sales, income, profits or other cash flow of the debtor or a related person, to any change in the value of any property of the debtor or a related person or to any dividend, partnership distribution or similar payment made by the debtor or a related person, and paid to a resident of the other State may also be taxed in the Contracting State. Any such interest may be taxed in that Contracting State according to the laws of that State. However, if the beneficial owner is a resident of the other Contracting State, the gross amount of the interest may be taxed at a rate not exceeding 15 percent.

The second class of interest is dealt with in subparagraph 5(b). This exception is consistent with the policy of Code sections 860E(e) and 860G(b) that excess inclusions with respect to a real estate mortgage investment conduit (REMIC) should bear full U.S. tax in all cases. Without a full tax at source foreign purchasers of residual interests would have a competitive advantage over U.S. purchasers at the time these interests are initially offered. Also, absent this rule, the U.S. fisc would suffer a revenue loss with respect to mortgages held in a REMIC because of opportunities for tax avoidance created by differences in the timing of taxable and economic income produced by these interests.

Relationship to Other Articles

Notwithstanding the foregoing limitations on source country taxation of interest, the saving clause of paragraph 4 of Article 1 (General Scope) permits the United States to tax its residents and citizens, subject to the special foreign tax credit rules of paragraph 4 of Article 22 (Relief from Double Taxation), as if the Convention had not come into force.

As with other benefits of the Convention, the benefits of Article 11 are available to a resident of the other State only if that resident is entitled to those benefits under the provisions of Article 21 (Limitation on Benefits).

ARTICLE 12 (ROYALTIES)

Article 12 provides rules for the taxation of royalties arising in one Contracting State and paid to a beneficial owner that is a resident of the other Contracting State.

Paragraph 1

Paragraph 1 generally grants to the State of residence the exclusive right to tax royalties beneficially owned by its residents and arising in the other Contracting State.

The term "beneficial owner" is not defined in the Convention, and is, therefore, defined under the internal law of the State of source. The beneficial owner of the royalty for purposes of Article 12 is the person to which the income is attributable under the laws of the source State. Thus, if a royalty arising in a Contracting State 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 royalty is not entitled to the benefits of Article 12. However, a royalty received by a nominee on behalf of a resident of that other State would be entitled to benefits. These limitations are confirmed by paragraph 4 of the OECD Commentary to Article 12.

Paragraph 2

Paragraph 2 provides that notwithstanding the provisions of paragraph 1, the following royalties may be taxed in the Contracting State in which they arise: royalties paid in consideration for the use of, or the right to use a trademark and any information concerning industrial, commercial or scientific experience provided in connection with a rental or franchise agreement that includes rights to use a trademark, and royalties paid in consideration for the use of or the right to use a motion picture film or work on film or videotape or other means of reproduction for use in connection with television. If, however, the beneficial owner of the royalty is a resident of the other Contracting State, the tax may not exceed 5 percent of the gross amount of the royalties.

Paragraph 3

Paragraph 2 defines the term "royalties," as used in Article 12, to include any consideration for the use of, or the right to use, any copyright of literary, artistic, scientific or other work (such as computer software and cinematographic films), any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial, or scientific experience. The term "royalties," however, does not include income from leasing personal property.

The term royalties is defined in the Convention and therefore is generally independent of domestic law. Certain terms used in the definition are not defined in the Convention, but these may be defined under domestic tax law. For example, the term "secret process or formulas" is found in the Code, and its meaning has been elaborated in the context of sections 351 and 367. See Rev. Rul. 55-17, 1955-1 C.B. 388; Rev. Rul. 64-56, 1964-1 C.B. 133; Rev. Proc. 69-19, 1969-2 C.B. 301.

Consideration for the use or right to use cinematographic films, or works on film, tape, or other means of reproduction in radio or television broadcasting is specifically included in the definition of royalties. It is intended that, with respect to any subsequent technological advances

in the field of radio or television broadcasting, consideration received for the use of such technology will also be included in the definition of royalties.

If an artist who is resident in one Contracting State records a performance in the other Contracting State, retains a copyrighted interest in a recording, and receives payments for the right to use the recording based on the sale or public playing of the recording, then the right of such other Contracting State to tax those payments is governed by Article 12. See Boulez v. Commissioner, 83 T.C. 584 (1984), aff'd, 810 F.2d 209 (D.C. Cir. 1986). By contrast, if the artist earns in the other Contracting State income covered by Article 16 (Entertainers and Sportsmen), for example, endorsement income from the artist's attendance at a film screening, and if such income also is attributable to one of the rights described in Article 12 (*e.g.*, the use of the artist's photograph in promoting the screening), Article 16 and not Article 12 is applicable to such income.

Computer software generally is protected by copyright laws around the world. Under the Convention, consideration received for the use, or the right to use, computer software is treated either as royalties or as business profits, depending on the facts and circumstances of the transaction giving rise to the payment.

The primary factor in determining whether consideration received for the use, or the right to use, computer software is treated as royalties or as business profits is the nature of the rights transferred. See Treas. Reg. section 1.861-18. The fact that the transaction is characterized as a license for copyright law purposes is not dispositive. For example, a typical retail sale of "shrink wrap" software generally will not be considered to give rise to royalty income, even though for copyright law purposes it may be characterized as a license.

The means by which the computer software is transferred are not relevant for purposes of the analysis. Consequently, if software is electronically transferred but the rights obtained by the transferee are substantially equivalent to rights in a program copy, the payment will be considered business profits.

The term "industrial, commercial, or scientific experience" (sometimes referred to as "know-how") has the meaning ascribed to it in paragraph 11 *et seq.* of the Commentary to Article 12 of the OECD Model. Consistent with that meaning, the term may include information that is ancillary to a right otherwise giving rise to royalties, such as a patent or secret process.

Know-how also may include, in limited cases, technical information that is conveyed through technical or consultancy services. It does not include general educational training of the user's employees, nor does it include information developed especially for the user, such as a technical plan or design developed according to the user's specifications. Thus, as provided in paragraph 11.3 of the Commentary to Article 12 of the OECD Model, the term "royalties" does not include payments received as consideration for after-sales service, for services rendered by a seller to a purchaser under a warranty, or for pure technical assistance.

The term "royalties" also does not include payments for professional services (such as architectural, engineering, legal, managerial, medical, software development services). For example, income from the design of a refinery by an engineer (even if the engineer employed know-how in the process of rendering the design) or the production of a legal brief by a lawyer is not income from the transfer of know-how taxable under Article 12, but is income from services taxable under either Article 7 (Business Profits) or Article 14 (Income from Employment). Professional services may be embodied in property that gives rise to royalties, however. Thus, if

a professional contracts to develop patentable property and retains rights in the resulting property under the development contract, subsequent license payments made for those rights would be royalties.

Paragraph 4

This paragraph provides an exception in cases where the beneficial owner of the royalties carries on business through a permanent establishment in the state of source and the royalties are attributable to that permanent establishment. In such cases the provisions of Article 7 will apply.

The provisions of paragraph 7 of Article 7 apply to this paragraph. For example, royalty income that is attributable to a permanent establishment and that accrues during the existence of the permanent establishment, but is received after the permanent establishment no longer exists, remains taxable under the provisions of Article 7, and not under this Article.

Paragraph 5

Paragraph 5 contains the source rule for royalties. Under paragraph 5, royalties are treated as arising in a Contracting State if paid by a resident of that State. As an exception, royalties that are attributable to a permanent establishment in a Contracting State and borne by the permanent establishment are considered to arise in that State. Where, however, the payor of the royalties is not a resident of either Contracting State, and the royalties are not borne by a permanent establishment in either Contracting State, but the royalties are for the use of, or the right to use, in one of the Contracting States, any property or right described in paragraph 3, the royalties are deemed to arise in that State.

Paragraph 6

Paragraph 6 provides that in cases involving special relationships between the payor and beneficial owner of royalties, Article 12 applies only to the extent the royalties would have been paid absent such special relationships (i.e., an arm's-length royalty). Any excess amount of royalties paid remains taxable according to the laws of the two Contracting States, with due regard to the other provisions of the Convention. If, for example, the excess amount is treated as a distribution of corporate profits under domestic law, such excess amount will be taxed as a dividend rather than as royalties, but the tax imposed on the dividend payment will be subject to the rate limitations of paragraph 2 of Article 10 (Dividends).

Relationship to Other Articles

Notwithstanding the foregoing limitations on source country taxation of royalties, the saving clause of paragraph 4 of Article 1 (General Scope) permits the United States to tax its residents and citizens, subject to the special foreign tax credit rules of paragraph 4 of Article 22 (Relief from Double Taxation), as if the Convention had not come into force.

As with other benefits of the Convention, the benefits of Article 12 are available to a resident of the other State only if that resident is entitled to those benefits under Article 21 (Limitation on Benefits).

ARTICLE 13 (CAPITAL GAINS)

Article 13 assigns either primary or exclusive taxing jurisdiction over gains from the alienation of property to the State of residence or the State of source.

Paragraph 1

Paragraph 1 of Article 13 preserves the non-exclusive right of the State of source to tax from the alienation of immovable property (real property) situated in that State. For purposes of paragraph 1, in all events the term "immovable property (real property) situated in the other State" includes a United States real property interest in the United States, as that term is defined in the Internal Revenue Code on the date of signature of the Convention, and as amended (without changing the general principles of paragraph 1). Thus, the United States preserves its right to collect the tax imposed by section 897 of the Code on gains derived by foreign persons from the disposition of United States real property interests, including gains arising from indirect dispositions described in section 897(h).

Paragraph 2

This paragraph defines the term "immovable property (real property) situated in the other Contracting State." The term includes real property referred to in Article 6 (i.e., an interest in the real property itself), rights to assets to be produced by the exploration or exploitation of the seabed and subsoil of that other State and their natural resources, including rights to interests in or the benefit of such assets, a "United States real property interest" (when the United States is the other Contracting State under paragraph 1), and, as specified in subparagraph 2(d), an equivalent interest in immovable property (real property) situated in Iceland.

Under section 897(c) of the Code the term "United States real property interest" includes shares in a U.S. corporation that owns sufficient U.S. real property interests to satisfy an asset-ratio test on certain testing dates. The term also includes certain foreign corporations that have elected to be treated as U.S. corporations for this purpose. Section 897(i).

Paragraph 3

Paragraph 3 of Article 13 deals with the taxation of certain gains from the alienation of movable property forming part of the business property of a permanent establishment that an enterprise of a Contracting State has in the other Contracting State. This also includes gains from the alienation of such a permanent establishment (alone or with the whole enterprise). Such gains may be taxed in the State in which the permanent establishment is located.

A resident of Iceland that is a partner in a partnership doing business in the United States generally will have a permanent establishment in the United States as a result of the activities of the partnership, assuming that the activities of the partnership rise to the level of a permanent establishment. Rev. Rul. 91-32, 1991-1 C.B. 107. Further, under paragraph 3, the United States generally may tax a partner's distributive share of income realized by a partnership on the disposition of movable property forming part of the business property of the partnership in the United States.

The gains subject to paragraph 3 may be taxed in the State in which the permanent establishment is located, regardless of whether the permanent establishment exists at the time of the alienation. This rule incorporates the rule of section 864(c)(6) of the Code. Accordingly, income that is attributable to a permanent establishment, but that is deferred and received after the permanent establishment no longer exists, may nevertheless be taxed by the State in which the permanent establishment was located.

Paragraph 4

This paragraph limits the taxing jurisdiction of the State of source with respect to gains from the alienation of ships, aircraft or containers operated in international traffic by the enterprise alienating the ship or aircraft and from property (other than real property) pertaining to the operation or use of such ships, aircraft, or containers.

Under paragraph 4, such income is taxable only in the Contracting State in which the alienator is resident. Notwithstanding paragraph 3, the rules of this paragraph apply even if the income is attributable to a permanent establishment maintained by the enterprise in the other Contracting State. This result is consistent with the allocation of taxing rights under Article 8 (Shipping and Air Transport).

Paragraph 5

Paragraph 5 grants to the State of residence of the alienator the exclusive right to tax gains from the alienation of property other than property referred to in paragraphs 1 through 4. For example, gain derived from shares, other than shares described in paragraphs 2 or 3, debt instruments and various financial instruments, may be taxed only in the State of residence, to the extent such income is not otherwise characterized as income taxable under another article (e.g., Article 10 (Dividends) or Article 11 (Interest)). Similarly gain derived from the alienation of tangible personal property, other than tangible personal property described in paragraph 3, may be taxed only in the State of residence of the alienator.

Gains derived by a resident of a Contracting State from real property located in a third state are not taxable in the other Contracting State, even if the sale is attributable to a permanent establishment located in the other Contracting State.

Paragraph 6

Paragraph 6 sets forth a rule which permits the imposition of certain expatriation taxes. This rule provides that notwithstanding paragraph 5 a Contracting State may tax gains from the alienation of shares or rights in a company, the capital of which is wholly or partly divided into shares, and that is a resident of that State, if the person alienating the shares or rights is an individual resident in the other Contracting State, but only if such individual was a resident of the first-mentioned State at any time during the five-year period preceding the alienation.

Relationship to Other Articles

Notwithstanding the foregoing limitations on taxation of certain gains by the State of source, the saving clause of paragraph 4 of Article 1 (General Scope) permits the United States to tax its citizens and residents as if the Convention had not come into effect. Thus, any limitation in this Article on the right of the United States to tax gains does not apply to gains of a U.S. citizen or resident.

The benefits of this Article are also subject to the provisions of Article 21 (Limitation on Benefits). Thus, only a resident of a Contracting State that satisfies one of the conditions in Article 21 is entitled to the benefits of this Article.

Additionally, the provisions of paragraph 6 shall be applied in conjunction with subparagraph 2(b) of Article 22 (Relief from Double Taxation).

ARTICLE 14 (INCOME FROM EMPLOYMENT)

Article 14 apportions taxing jurisdiction over remuneration derived by a resident of a Contracting State as an employee between the States of source and residence.

Paragraph 1

The general rule of Article 14 is contained in paragraph 1. Remuneration derived by a resident of a Contracting State as an employee may be taxed by the State of residence, and the remuneration also may be taxed by the other Contracting State to the extent derived from employment exercised (*i.e.*, services performed) in that other Contracting State. Paragraph 1 also provides that the more specific rules of Articles 15 (Directors' Fees), 17 (Pensions, Social Security, and Annuities), and 19 (Government Service) 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 under Article 14, it may not have the right to tax that income under the Convention if the income is described, for example, in Article 17 (Pensions, Social Security, and Annuities) and is not taxable in the State of source under the provisions of that article.

Article 14 applies to any form of compensation for employment, including payments in kind. Paragraph 1.1 of the Commentary to Article 16 of the OECD Model now confirms that interpretation.

Consistent with section 864(c)(6) of the Code, Article 14 also applies regardless of the timing of actual payment for services. Consequently, a person who receives the right to a future payment in consideration for services rendered in a Contracting State would be taxable in that State even if the payment is received at a time when the recipient is a resident of the other Contracting State. Thus, a bonus paid to a resident of a Contracting State with respect to services performed in the other Contracting State with respect to a particular taxable year would be subject to Article 14 for that year even if it was paid after the close of the year. An annuity received for services performed in a taxable year could be subject to Article 14 despite the fact that it was paid in subsequent years. In that case, it would be necessary to determine whether the payment constitutes deferred compensation, taxable under Article 14, or a qualified pension subject to the rules of Article 17 (Pensions, Social Security, and Annuities). Article 14 also applies to income derived from the exercise of stock options granted with respect to services performed in the host State, even if those stock options are exercised after the employee has left the source country. If Article 14 is found to apply, whether such payments were taxable in the State where the employment was exercised would depend on whether the tests of paragraph 2 were satisfied in the year in which the services to which the payment relates were performed.

Paragraph 2

Paragraph 2 sets forth an exception to the general rule that employment income may be taxed in the State where it is exercised. Under paragraph 2, the State where the employment is

exercised may not tax the income from the employment if three conditions are satisfied: (a) 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 during the relevant taxable year (i.e., in the United States, the calendar year in which the services are performed); (b) the remuneration is paid by, or on behalf of, an employer who is not a resident of that other Contracting State; and (c) the remuneration is not borne as a deductible expense by a permanent establishment that the employer has in that other State. In order for the remuneration to be exempt from tax in the source State, all three conditions must be satisfied. This exception is identical to that set forth in the OECD Model.

The 183-day period in condition (a) is to be measured using the "days of physical presence" method. Under this method, the days that are counted include any day in which a part of the day is spent in the host country. (Rev. Rul. 56-24, 1956-1 C.B. 851.) Thus, days that are counted include the days of arrival and departure; weekends and holidays on which the employee does not work but is present within the country; vacation days spent in the country before, during or after the employment period, unless the individual's presence before or after the employment can be shown to be independent of his presence there for employment purposes; and time during periods of sickness, training periods, strikes, etc., when the individual is present but not working. If illness prevented the individual from leaving the country in sufficient time to qualify for the benefit, those days will not count. Also, any part of a day spent in the host country while in transit between two points outside the host country is not counted. If the individual is a resident of the host country for part of the taxable year concerned and a nonresident for the remainder of the year, the individual's days of presence as a resident do not count for purposes of determining whether the 183-day period is exceeded.

Conditions (b) and (c) are intended to ensure that a Contracting State will not be required to allow a deduction to the payor for compensation paid and at the same time to exempt the employee on the amount received. Accordingly, if a foreign person pays the salary of an employee who is employed in the host State, but a host State corporation or permanent establishment reimburses the payor with a payment that can be identified as a reimbursement, neither condition (b) nor (c), as the case may be, will be considered to have been fulfilled.

The reference to remuneration "borne by" a permanent establishment is understood to encompass all expenses that economically are incurred and not merely expenses that are currently deductible for tax purposes. Accordingly, the expenses referred to include expenses that are capitalizable as well as those that are currently deductible. Further, salaries paid by residents that are exempt from income taxation may be considered to be borne by a permanent establishment notwithstanding the fact that the expenses will be neither deductible nor capitalizable since the payor is exempt from tax.

Paragraph 3

Paragraph 3 contains a special rule applicable to remuneration for services performed by 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 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, for example, it may also include others, such as entertainers, lecturers, etc., employed by the shipping company to serve on the ship throughout its voyage. The use of the term "regular complement" is intended to clarify that a person who exercises his employment as, for example, an insurance salesman while aboard a ship or aircraft is not covered by this paragraph.

If a U.S. citizen who is resident in Iceland performs services as an employee in the United States and meets the conditions of paragraph 2 for source country exemption, he nevertheless is taxable in the United States by virtue of the saving clause of paragraph 4 of Article 1 (General Scope), subject to the special foreign tax credit rule of paragraph 4 of Article 22 (Relief from Double Taxation).

ARTICLE 15 (DIRECTORS' FEES)

This Article provides that a Contracting State may tax the fees and other compensation 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. This rule is an exception to the more general rules of Articles 7 (Business Profits) and 14 (Income from Employment). Thus, for example, in determining whether a director's fee paid to a non-employee director is subject to tax in the country of residence of the corporation, it is not relevant to establish whether the fee is attributable to a permanent establishment in that State.

Under this Article, 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. Under U.S. law, however, services performed by a nonresident may not be taxed unless they are performed in the United States (unless that nonresident is a U.S. citizen, and therefore subject to the saving clause of paragraph 4 of Article 1 (General Scope)).

ARTICLE 16 (ENTERTAINERS AND SPORTSMEN)

This Article deals with the taxation in a Contracting State of 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 one who performs 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, in some circumstances, over those of Articles 7 (Business Profits) and 14 (Income from Employment).

This Article applies only with respect to the income of entertainers 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 7 and 14. In addition, except as provided in paragraph 2, income earned by juridical persons is not covered by Article 16.

Paragraph 1

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. Under the paragraph, income derived by an individual resident of a Contracting State from activities as an entertainer or sportsman exercised in the other Contracting State may be taxed in that other State if the amount of the gross receipts derived by the performer exceeds $20,000 (or its equivalent in Icelandic kronur) for the taxable year. The $20,000 includes expenses reimbursed to the individual or borne on his behalf. If the gross receipts exceed $20,000, the full amount, not just the excess, may be taxed in the State of performance.

The Convention introduces the monetary threshold to distinguish between two groups of entertainers and athletes -- those who are paid relatively 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 relatively modest amounts and are, therefore, not easily distinguishable from those who earn other types of personal service income.

Tax may be imposed under paragraph 1 even if the performer would have been exempt from tax under Article 7 or 14. On the other hand, if the performer would be exempt from host-country tax under Article 16, but would be taxable under either Article 7 or 14, tax may be imposed under either of those Articles. Thus, for example, if a performer derives remuneration from his activities in an independent capacity, and the performer does not have a permanent establishment in the host State, he may be taxed by the host State in accordance with Article 16 if his remuneration exceeds $20,000 annually, despite the fact that he generally would be exempt from host State taxation under Article 7. However, a performer who receives less than the $20,000 threshold amount and therefore is not taxable under Article 16 nevertheless may be subject to tax in the host country under Article 7 or 14 if the tests for host-country taxability under the relevant Article are met. For example, if an entertainer who is an independent contractor earns $14,000 of income in a State for the calendar year, but the income is attributable to his permanent establishment in the State of performance, that State may tax his income under Article 7.

Nothing shall preclude a Contracting State from withholding tax from such payments according to its domestic laws. However, if according to the provisions of this Article, such remuneration or income may only be taxed in the other Contracting State, the first-mentioned Contracting State shall make a refund of the tax so withheld upon a duly filed claim. Such claim must be filed with the tax authorities that have collected the withholding tax within five years after the close of the calendar year in which the tax was withheld.

As explained in paragraph 9 of the Commentary to Article 17 of the OECD Model, Article 16 of the Convention applies to all income connected with a performance by the entertainer, such as appearance fees, award or prize money, and a share of the gate receipts. Income derived from a Contracting State by a performer who is a resident of the other Contracting State 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, such as Article 12 (Royalties) or Article 7. For example, if an entertainer receives royalty income from the sale of live recordings, the royalty income would be subject to the provisions of Article 12, even if the performance was conducted in the source country, although the entertainer could be taxed in the source country with respect to income from the performance itself under Article 16 if the dollar threshold is exceeded.

In determining whether income falls under Article 16 or another article, the controlling factor will be whether the income in question is predominantly attributable to the performance itself or to other activities or property rights. For instance, a fee paid to a performer for endorsement of a performance in which the performer will participate would be considered to be so closely associated with the performance itself that it normally would fall within Article 16. Similarly, a sponsorship fee paid by a business in return for the right to attach its name to the performance would be so closely associated with the performance that it would fall under Article 16 as well. As indicated in paragraph 9 of the Commentary to Article 17 of the OECD Model, however, a cancellation fee would not be considered to fall within Article 16 but would be dealt with under Article 7 or 14.

As indicated in paragraph 4 of the Commentary to Article 17 of the OECD Model, where an individual fulfills a dual role as performer and non-performer (such as a player-coach or an actor-director), but his role in one of the two capacities is negligible, the predominant character of the individual's activities should control the characterization of those activities. In other cases there should be an apportionment between the performance-related compensation and other compensation.

Consistent with Article 14, Article 16 also applies regardless of the timing of actual payment for services. Thus, a bonus paid to a resident of a Contracting State with respect to a performance in the other Contracting State during a particular taxable year would be subject to Article 16 for that year even if it was paid after the close of the year. The determination as to whether the $20,000 threshold has been exceeded is determined separately with respect to each year of payment. Accordingly, if an actor who is a resident of one Contracting State receives residual payments over time with respect to a movie that was filmed in the other Contracting State, the payments do not have to be aggregated from one year to another to determine whether the total payments have finally exceeded $20,000. Otherwise, residual payments received many years later could retroactively subject all earlier payments to tax by the other Contracting State.

Paragraph 2

Paragraph 2 is intended to address the potential for circumvention of the rule in paragraph 1 when a performer's income does not accrue directly to the performer himself, but to another person. Foreign performers frequently 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 circumvention of paragraph 1 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 performance (a "star company"). The performer may act as an "employee," receive a modest salary, and arrange to receive the remainder of the income from his performance from the company in another form or at a later time. In such case, absent the provisions of paragraph 2, the income arguably could escape host-country tax because the company earns business profits but has no permanent establishment in that country. The performer may largely or entirely escape host-country tax by receiving only a small salary, perhaps small enough to place him below the dollar threshold in paragraph 1. The performer might arrange to receive further payments in a later year, when he is not subject to host-country tax, perhaps as dividends or liquidating distributions.

Paragraph 2 seeks to prevent this type of abuse while at the same time protecting the taxpayers' rights to the benefits of the Convention when there is a legitimate employee-employer relationship between the performer and the person providing his services. Under paragraph 2, when the income accrues to a person other than the performer, and the performer or related persons participate, directly or indirectly, in the receipts or 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 or income from employment (Article 14). In cases where paragraph 2 is applicable, the income of the "employer" may be subject to tax in the host Contracting State even if it has no permanent establishment in the host country. Taxation under paragraph 2 is on the person providing the services of the performer. This paragraph does not affect the rules of paragraph 1, which apply to the performer himself. The income taxable by virtue of paragraph 2 is reduced to the extent of salary payments to the performer, which fall 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 performer) if that other person has control over, or the right to receive, gross income in respect of the services of the performer. 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 performer nor any persons related to the performer participate directly or indirectly in the receipts or profits of the person providing the services of the performer. Assume, for example, that a circus owned by a U.S. corporation performs in the other Contracting State, and promoters of the performance in the other State pay the circus, which, in turn, pays salaries to the circus performers. The circus is determined to have no permanent establishment in that State. Since the circus performers 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 host-country tax. Whether the salaries of the circus performers are subject to host-country tax under this Article depends on whether they exceed the $20,000 threshold in paragraph 1.

Since pursuant to Article 1 (General Scope) the Convention only applies to persons who are residents of one of the Contracting States, income of the star company would not be eligible for benefits of the Convention if the company is not a resident of one of the Contracting States.

Relationship to other Articles

This Article is subject to the provisions of the saving clause of paragraph 4 of Article 1 (General Scope). Thus, if an entertainer or a sportsman who is resident in the other Contracting State 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 4 of Article 22 (Relief From Double Taxation). In addition, benefits of this Article are subject to the provisions of Article 21 (Limitation On Benefits).

ARTICLE 17 (PENSIONS, SOCIAL SECURITY, AND ANNUITIES)

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

Paragraph 1

Paragraph 1 provides that distributions from pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment are taxable only in the State of residence of the beneficiary. The term "pensions and other similar remuneration" includes both periodic and single sum payments.

The phrase "pensions and other similar remuneration" is intended to encompass payments made by qualified private retirement plans. In the United States, the plans encompassed by Paragraph 1 include: qualified plans under section 401(a), individual retirement plans (including individual retirement plans that are part of a simplified employee pension plan that satisfies section 408(k), individual retirement accounts and section 408(p) accounts), section 403(a) qualified annuity plans, and section 403(b) plans. Distributions from section 457 plans may also fall under Paragraph 1 if they are not paid with respect to government services covered

by Article 19. In Iceland, the term pension applies to any pension fund or pension plan qualified under the Pension Act or any identical or substantially similar schemes which are created under any law enacted after the signature of the Convention. The competent authorities may agree that distributions from other plans that generally meet similar criteria to those applicable to the listed plans also qualify for the benefits of Paragraph 1.

Pensions in respect of government services covered by Article 18 are not covered by this paragraph. They are covered either by paragraph 2 of this Article, if they are in the form of social security benefits, or by paragraph 2 of Article 18 (Government Service). Thus, Article 18 generally covers section 457(g), 401(a), 403(a), and 403(b) plans established for government employees, including the Thrift Savings Plan (section 7701(j)).

Paragraph 2

The treatment of social security benefits is dealt with in paragraph 2. This paragraph provides that, notwithstanding the provision of paragraph 1 under which private pensions are taxable exclusively in the State of residence of the beneficial owner, payments made by one of the Contracting States under the provisions of its social security or similar legislation to a resident of Iceland or to a citizen of the United States will be taxable only in the Contracting State making the payment. The reference to U.S. citizens is necessary to ensure that a social security payment by Iceland to a U.S. citizen who is not resident in the United States will not be taxable by the United States.

This paragraph applies to social security beneficiaries whether they have contributed to the system as private sector or Government employees. The phrase "similar legislation" is intended to refer to United States tier 1 Railroad Retirement benefits.

Paragraph 3

Under paragraph 3, annuities that are derived and beneficially owned by a resident of a Contracting State are taxable only in that State. An annuity, as the term is used in this paragraph, means a stated sum paid periodically at stated times during a specified number of years, under an obligation to make the payment in return for adequate and full consideration (other than for services rendered). An annuity received in consideration for services rendered would be treated as either deferred compensation that is taxable in accordance with Article 14 (Income from Employment) or a pension that is subject to the rules of paragraph 1.

Paragraph 4

Paragraph 4 provides that, if a resident of a Contracting State participates in a pension fund established in the other Contracting State, the State of residence will not tax the income of the pension fund with respect to that resident until a distribution is made from the pension fund. Thus, for example, if a U.S. citizen contributes to a U.S. qualified plan while working in the United States and then establishes residence in Iceland, paragraph 1 prevents Iceland from taxing currently the plan's earnings and accretions with respect to that individual. When the resident receives a distribution from the pension fund, that distribution may be subject to tax in the State of residence, subject to paragraph 1.

Relationship to other Articles

Paragraphs 1 and 3 of Article 17 are subject to the saving clause of paragraph 4 of Article 1 (General Scope). Thus, a U.S. citizen who is resident in the other Contracting State, and receives either a pension, annuity or alimony payment from the United States, may be subject to U.S. tax on the payment, notwithstanding the rules in those three paragraphs that give the State of residence of the recipient the exclusive taxing right. Paragraphs 2 and 4 are excepted from the saving clause by virtue of subparagraph 5(a) of Article 1. Thus, the United States will not tax U.S. citizens and residents on the income described in those paragraphs even if such amounts otherwise would be subject to tax under U.S. law.

ARTICLE 18 (GOVERNMENT SERVICE)

Paragraph 1

Subparagraphs 1(a) and 1(b) deal with the taxation of government compensation (other than a pension addressed in paragraph 2). Subparagraph 1(a) provides that remuneration paid from the public funds of a Contracting State or its political subdivisions or local authorities to any individual who is rendering services to that State, political subdivision or local authority, which are in the discharge of governmental functions, is exempt from tax by the other State. Under subparagraph 1(b), such payments are, however, taxable exclusively in the other State (i.e., the host State) if the services are rendered in that other State and the individual is a resident of that State who is either a national of that State or a person who did not become resident of that State solely for purposes of rendering the services. The paragraph applies to anyone performing services for a government, whether as a government employee, an independent contractor, or an employee of an independent contractor.

Paragraph 2

Paragraph 2 deals with the taxation of pensions 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 in the discharge of functions of a governmental nature to that State or subdivision or authority. Subparagraph 1(a) provides that such pensions are taxable only in that State. Subparagraph 1(b) provides an exception under which such pensions are taxable only in the other State if the individual is a resident of, and a national of, that other State.

Pensions paid to retired civilian and military employees of a Government of either State are intended to be covered under paragraph 2. When benefits paid by a State in respect of services rendered to that State or a subdivision or authority are in the form of social security benefits, however, those payments are covered by paragraph 2 of Article 17 (Pensions, Social Security, Annuities, Alimony, and Child Support). As a general matter, the result will be the same whether Article 17 or 19 applies, since social security benefits are taxable exclusively by the source country and so are government pensions. The result will differ only when the payment is made to a citizen and resident of the other Contracting State, who is not also a citizen of the paying State. In such a case, social security benefits continue to be taxable at source while government pensions become taxable only in the residence country.

Paragraph 3

Paragraph 3 provides that the remuneration described in paragraph 1 will be subject to the rules of Articles 14 (Income from Employment), 15 (Directors' Fees), 16 (Entertainers and Sportsmen) or 17 if the recipient of the income is employed by a business conducted by a government.

Relationship to other Articles

Under subparagraph 5(b) of Article 1 (General Scope), the saving clause (paragraph 4 of Article 1) does not apply to the benefits conferred by one of the States under Article 18 if the recipient of the benefits is neither a citizen of that State, nor a person who has been admitted for permanent residence there (i.e., in the United States, a "green card" holder). Thus, a resident of a Contracting State who in the course of performing functions of a governmental nature becomes a resident of the other State (but not a permanent resident), would be entitled to the benefits of this Article. Similarly, an individual who receives a pension paid by the Government of Iceland in respect of services rendered to the Government of Iceland shall be taxable on this pension only in Iceland unless the individual is a U.S. citizen or acquires a U.S. green card.

ARTICLE 19 (STUDENTS AND TRAINEES)

This Article provides rules for host-country taxation of visiting students and business trainees. Persons who meet the tests of the Article will be exempt from tax in the State that they are visiting with respect to designated classes of income. Several conditions must be satisfied in order for an individual to be entitled to the benefits of this Article.

Paragraph 1

Paragraph 1 provides that an individual who is a resident of one Contracting State at the time he becomes temporarily present in the other Contracting State and who is temporarily present therein for the primary purpose of studying at a university or other recognized educational institution in that other Contracting State, securing training required to qualify him to practice a profession or professional specialty, or studying or doing research as a recipient of a grant, allowance, or award from a governmental, religious, charitable, scientific, literary, or educational organization, will be exempt from tax by that other Contracting State for a period not exceeding five taxable years from the date of his arrival in that other Contracting State on:

(1) Gifts from abroad for the purpose of his maintenance, education, study, research or training;

(2) The grant, allowance, or award; and

(3) Income from personal services performed in the other Contracting State not in excess of $9,000 or its equivalent in Icelandic kronur for any taxable year.

Paragraph 2

Under paragraph 2, an individual who is a resident of one Contracting State at the time he becomes temporarily present in the other Contracting State and who is temporarily present therein as an employee of, or under contract with, a resident of the first-mentioned Contracting State, for the primary purpose of acquiring technical, professional, or business experience from a

person other than that resident of the first-mentioned Contracting State or other than a person related to such resident, or studying at a university or other recognized educational institution in that other Contracting State, will be exempt from tax by that other Contracting State for a period of twelve consecutive months on income from personal services not in excess of $9,000 or its equivalent in Icelandic kronur.

Paragraph 3

Paragraph 3 provides an exemption for residents of one Contracting State who become temporarily present in the other Contracting State for purposes of training, research or study in a program sponsored by the other Contracting State. The exemption is available to an individual who is a resident of one Contracting State at the time he becomes temporarily present in the other Contracting State and who is temporarily present in that other Contracting State for a period not exceeding one year, as a participant in a program sponsored by the other Contracting State, for the primary purpose of training, research, or study. A person meeting these requirements will be exempt from tax by the other Contracting State with respect to his income from personal services in respect of such training, research, or study performed in that other Contracting State in an aggregate amount not in excess of $9,000 or its equivalent in Icelandic kronur.

Relationship to other Articles

The saving clause of paragraph 4 of Article 1 (General Scope) does not apply to this Article with respect to an individual who is neither a citizen of the host State nor an individual who has been admitted for permanent residence there. The saving clause, however, does apply with respect to citizens and permanent residents of the host State. Thus, a U.S. citizen who is a resident of Iceland and who visits the United States as a full-time student at an accredited university will not be exempt from U.S. tax on remittances from abroad that otherwise constitute U.S. taxable income. An individual, however, who is not a U.S. citizen, and who visits the United States as a student and remains long enough to become a resident under U.S. law, but does not become a permanent resident (i.e., does not acquire a green card), will be entitled to the full benefits of the Article.

ARTICLE 20 (OTHER INCOME)

Article 20 generally assigns taxing jurisdiction over income not dealt with in the other articles (Articles 6 (Income from Immovable Property (Real Property)) through 19 (Students and Trainees)) of the Convention to the State of residence of the beneficial owner of the income. In order for an item of income to be "dealt with" in another article it must be the type of income described in the article and, in most cases, it must have its source in a Contracting State. For example, all royalty income that arises in a Contracting State and that is beneficially owned by a resident of the other Contracting State is "dealt with" in Article 12 (Royalties). However, profits derived in the conduct of a business are "dealt with" in Article 7 (Business Profits) whether or not they have their source in one of the Contracting States.

Examples of items of income covered by Article 20 include income from gambling, punitive (but not compensatory) damages and covenants not to compete. The article would also apply to income from a variety of financial transactions, where such income does not arise in the course of the conduct of a trade or business. For example, income from notional principal contracts and other derivatives would fall within Article 20 if derived by persons not engaged in the trade or business of dealing in such instruments, unless such instruments were being used to

hedge risks arising in a trade or business. It would also apply to securities lending fees derived by an institutional investor. Further, in most cases guarantee fees paid within an intercompany group would be covered by Article 20, unless the guarantor were engaged in the business of providing such guarantees to unrelated parties.

Article 20 also applies to items of income that are not dealt with in the other articles because of their source or some other characteristic. For example, Article 11 (Interest) addresses only the taxation of interest arising in a Contracting State. Interest arising in a third State that is not attributable to a permanent establishment, therefore, is subject to Article 20.

Distributions from partnerships are not generally dealt with under Article 20 because partnership distributions generally do not constitute income. Under the Code, partners include in income their distributive share of partnership income annually, and partnership distributions themselves generally do not give rise to income. This would also be the case under U.S. law with respect to distributions from trusts. Trust income and distributions that, under the Code, have the character of the associated distributable net income would generally be covered by another article of the Convention. See Code section 641 et seq.

Paragraph 1

The general rule of Article 20 is contained in paragraph 1. Items of income not dealt with in other articles and beneficially owned by a resident of a Contracting State will be taxable only in the State of residence. This exclusive right of taxation applies whether or not the residence State exercises its right to tax the income covered by the Article.

The reference in this paragraph to "items of income beneficially owned by a resident of a Contracting State" rather than simply "items of income of a resident of a Contracting State," as in the OECD Model, is intended merely to make explicit the implicit understanding in other treaties that the exclusive residence taxation provided by paragraph 1 applies only when a resident of a Contracting State is the beneficial owner of the income. Thus, source taxation of income not dealt with in other articles of the Convention is not limited by paragraph 1 if it is nominally paid to a resident of the other Contracting State, but is beneficially owned by a resident of a third State. However, income received by a nominee on behalf of a resident of that other State would be entitled to benefits.

The term "beneficially owned" 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 person who beneficially owns the income for purposes of Article 20 is the person to which the income is attributable for tax purposes under the laws of the source State.

Paragraph 2

This paragraph provides an exception to the general rule of paragraph 1 for income that is attributable to a permanent establishment maintained in a Contracting State by a resident of the other Contracting State. The taxation of such income is governed by the provisions of Article 7 (Business Profits). Therefore, income arising outside the United States that is paid in respect of a right or property that is effectively connected with a permanent establishment maintained in the United States by a resident of Iceland generally would be taxable by the United States under the provisions of Article 7. This would be true even if the income is sourced in a third state.

Relationship to Other Articles

This Article is subject to the saving clause of paragraph 4 of Article 1 (General Scope). Thus, the United States may tax the income of a resident of Iceland that is not dealt with elsewhere in the Convention, if that resident is a citizen of the United States. The Article is also subject to the provisions of Article 21 (Limitation On Benefits). Thus, if a resident of Iceland earns income that falls within the scope of paragraph 1 of Article 21, but that is taxable by the United States under U.S. law, the income would be exempt from U.S. tax under the provisions of Article 20 only if the resident satisfies one of the tests of Article 21 for entitlement to benefits.

ARTICLE 21 (LIMITATION ON BENEFITS)

Article 21 contains anti-treaty-shopping provisions that are intended to prevent residents of third countries from benefiting from what is intended to be a reciprocal agreement between two countries. In general, the provision does not rely on a determination of purpose or intention but instead sets forth a series of objective tests. A resident of a Contracting State that satisfies one of the tests will receive benefits regardless of its motivations in choosing its particular business structure.

The structure of the Article is as follows: Paragraph 1 states the general rule that residents are entitled to benefits otherwise accorded to residents only to the extent provided in the Article. Paragraph 2 lists a series of attributes of a resident of a Contracting State, the presence of any one of which will entitle that person to all the benefits of the Convention. Paragraph 3 provides a so-called "derivative benefits" test under which certain categories of income may qualify for benefits. Paragraph 4 provides that, regardless of whether a person qualifies for benefits under paragraph 2, benefits may be granted to that person with regard to certain income earned in the conduct of an active trade or business. Paragraph 5 provides special rules for so-called "triangular cases" notwithstanding the other provisions of Article 21. Paragraph 6 provides special rules for income from so-called "disproportionate shares" notwithstanding the other provisions of Article 21. Paragraph 7 provides that benefits also may be granted if the competent authority of the State from which benefits are claimed determines that it is appropriate to provide benefits in that case. Paragraph 8 defines certain terms used in the Article.

Paragraph 1

Paragraph 1 provides that a resident of a Contracting State will be entitled to the benefits otherwise accorded to residents of a Contracting State under the Convention only to the extent provided in the Article. The benefits otherwise accorded to residents under the Convention include all limitations on source-based taxation under Articles 6 (Income from Immovable Property (Real Property) through 20 (Other Income), the treaty-based relief from double taxation provided by Article 22 (Relief from Double Taxation), and the protection afforded to residents of a Contracting State under Article 23 (Non-Discrimination). Some provisions do not require that a person be a resident in order to enjoy the benefits of those provisions. Article 24 (Mutual Agreement Procedure) is not limited to residents of the Contracting States, and Article 26 (Members of Diplomatic Missions and Consular Posts) applies to diplomatic agents or consular officials regardless of residence. Article 21 accordingly does not limit the availability of treaty benefits under these provisions.

Article 21 and the anti-abuse provisions of domestic law complement each other, as Article 21 effectively 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 (*e.g.*, business purpose, substance-over-form, step transaction or conduit principles) determine whether a particular transaction should be recast in accordance with its substance. Thus, internal law principles of the source Contracting State may be applied to identify the beneficial owner of an item of income, and Article 21 then will be applied to the beneficial owner to determine if that person is entitled to the benefits of the Convention with respect to such income.

Paragraph 2

Paragraph 2 has five subparagraphs, each of which describes a category of residents that are entitled to all benefits of the Convention.

It is intended that the provisions of paragraph 2 will be self executing. Unlike the provisions of paragraph 7, discussed below, claiming benefits under paragraph 2 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.

Individuals -- Subparagraph 2(a)

Subparagraph 2(a) provides that individual residents of a Contracting State will be entitled to all treaty benefits. If such an individual receives income as a nominee on behalf of a third country resident, benefits may 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.

Governments -- Subparagraph 2(b)

Subparagraph 2(b) provides that the Contracting States and any political subdivision or local authority thereof will be entitled to all benefits of the Convention.

Publicly-Traded Corporations -- Subparagraph 2(c)(i)

Subparagraph 2(c) applies to two categories of companies: publicly traded companies and subsidiaries of publicly traded companies. A company resident in a Contracting State is entitled to all the benefits of the Convention under clause (i) of subparagraph 2(c) if the principal class of its shares is regularly traded on one or more recognized stock exchanges and the company satisfies at least one of the following additional requirements: first, the company's principal class of shares is primarily traded on one or more recognized stock exchanges located in the Contracting State of which the company is a resident; or, second, the company's primary place of management and control is in its State of residence.

The term "recognized stock exchange" is defined in subparagraph 8(b). It includes (i) the NASDAQ System 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; (ii) the Icelandic Stock Exchange; (iii) the stock exchanges of Amsterdam, Brussels, Copenhagen, Frankfurt, Hamburg, Helsinki, London, Oslo, Paris, Stockholm, Sydney, Tokyo, and Toronto; and (iv) any other stock exchange agreed upon by the competent authorities of the Contracting States.

If a company has only one class of shares, it is only necessary to consider whether the shares of that class meet the relevant trading requirements. If the company has more than one class of shares, it is necessary as an initial matter to determine which class or classes constitute the "principal class of shares". The term "principal class of shares" is defined in subparagraph 8(a) to mean the ordinary or common shares of the company representing the majority of the aggregate voting power and value of the company. If the company does not have a class of ordinary or common shares representing the majority of the aggregate voting power and value of the company, then the "principal class of shares" is that class or any combination of classes of shares that represents, in the aggregate, a majority of the voting power and value of the company. Although in a particular case involving a company with several classes of shares it is conceivable that more than one group of classes could be identified that account for more than 50% of the shares, it is only necessary for one such group to satisfy the requirements of this subparagraph in order for the company to be entitled to benefits. Benefits would not be denied to the company even if a second, non-qualifying, group of shares with more than half of the company's voting power and value could be identified.

The term "regularly traded" is not defined in the Convention. In accordance with paragraph 2 of Article 3 (General Definitions), this term will be defined by reference to the domestic tax laws of the State from which treaty benefits are sought, generally the source State. In the case of the United States, this term is understood to have the meaning it has under Treas. Reg. section 1.884-5(d)(4)(i)(B), relating to the branch tax provisions of the Code. Under these regulations, a class of shares is considered to be "regularly traded" if two requirements are met: trades in the class of shares are made in more than de minimis quantities on at least 60 days during the taxable year, and the aggregate number of shares in the class traded during the year is at least 10 percent of the average number of shares outstanding during the year. Sections 1.884-5(d)(4)(i)(A), (ii) and (iii) will not be taken into account for purposes of defining the term "regularly traded" under the Convention.

The regular trading requirement can be met by trading on any recognized exchange or exchanges located in either State. Trading on one or more recognized stock exchanges may be aggregated for purposes of this requirement. Thus, a U.S. company could satisfy the regularly traded requirement through trading, in whole or in part, on a recognized stock exchange located in Iceland. Authorized but unissued shares are not considered for purposes of this test.

The term "primarily traded" is not defined in the Convention. In accordance with paragraph 2 of Article 3, this term will have the meaning it has under the laws of the State concerning the taxes to which the Convention applies, generally the source State. In the case of the United States, this term is understood to have the meaning it has under Treas. Reg. section 1.884-5(d)(3), relating to the branch tax provisions of the Code. Accordingly, stock of a corporation is "primarily traded" if the number of shares in the company's principal class of shares that are traded during the taxable year on all recognized stock exchanges in the Contracting State of which the company is a resident exceeds the number of shares in the company's principal class of shares that are traded during that year on established securities markets in any other single foreign country.

A company whose principal class of shares is regularly traded on a recognized exchange but cannot meet the primarily traded test may claim treaty benefits if its primary place of management and control is in its country of residence. This test should be distinguished from the "place of effective management" test which is used in the OECD Model and by many other countries to establish residence. In some cases, the place of effective management test has been interpreted to mean the place where the board of directors meets. By contrast, the primary place

of management and control test looks to where day-to-day responsibility for the management of the company (and its subsidiaries) is exercised. The company's primary place of management and control will be located in the State in which the company is a resident only if the executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company (including direct and indirect subsidiaries) in that State than in the other State or any third state, and the staff that support the management in making those decisions are also based in that State. Thus, the test looks to the overall activities of the relevant persons to see where those activities are conducted. In most cases, it will be a necessary, but not a sufficient, condition that the headquarters of the company (that is, the place at which the Chief Executive Officer and other top executives normally are based) be located in the Contracting State of which the company is a resident.

To apply the test, it will be necessary to determine which persons are to be considered "executive officers and senior management employees". In most cases, it will not be necessary to look beyond the executives who are members of the Board of Directors (the "inside directors") in the case of a U.S. company. That will not always be the case, however; in fact, the relevant persons may be employees of subsidiaries if those persons make the strategic, financial and operational policy decisions. Moreover, it would be necessary to take into account any special voting arrangements that result in certain board members making certain decisions without the participation of other board members.

Subsidiaries of Publicly-Traded Corporations -- Subparagraph 2(c)(ii)

A company resident in a Contracting State is entitled to all the benefits of the Convention under clause (ii) of subparagraph 2(c) if five or fewer publicly traded companies described in clause (i) are the direct or indirect owners of at least 50 percent of the aggregate vote and value of the company's shares. If the publicly-traded companies are indirect owners, however, each of the intermediate companies must be a resident of one of the Contracting States.

Thus, for example, a company that is a resident of Iceland, all the shares of which are owned by another company that is a resident of Iceland, would qualify for benefits under the Convention if the principal class of shares of the parent company are regularly and primarily traded on a recognized stock exchange in Iceland. However, such a subsidiary would not qualify for benefits under clause (ii) if the publicly traded parent company were a resident of a third state, for example, and not a resident of the United States or Iceland. Furthermore, if a parent company in Iceland indirectly owned the bottom-tier company through a chain of subsidiaries, each such subsidiary in the chain, as an intermediate owner, must be a resident of the United States or Iceland in order for the subsidiary to meet the test in clause (ii).

Tax Exempt Organizations -- Subparagraph 2(d)

Subparagraph 2(d) provides rules by which the tax exempt organizations described in paragraph 2 of Article 4 (Resident) will be entitled to all the benefits of the Convention. A pension scheme described in paragraph 2(a) of Article 4 or an employee benefits plan described in paragraph 2(b) of Article 4 will qualify for benefits if more than fifty percent of the beneficiaries, members or participants of the organization are individuals resident in either Contracting State. For purposes of this provision, the term "beneficiaries" should be understood to refer to the persons receiving benefits from the organization. On the other hand, an organization resident in a Contracting State that is established exclusively for religious,

charitable, scientific, artistic, cultural, or educational purposes automatically qualifies for benefits, without regard to the residence of its beneficiaries or members.

Ownership/Base Erosion -- Subparagraph 2(e)

Subparagraph 2(e) provides an additional method to qualify for treaty benefits that applies to any form of legal entity that is a resident of a Contracting State. The test provided in subparagraph 2(e), the so-called ownership and base erosion test, is a two-part test. Both prongs of the test must be satisfied for the resident to be entitled to treaty benefits under subparagraph 2(e).

The ownership prong of the test, under clause (i), requires that 50 percent or more of each class of shares or other beneficial interests in the person is owned, directly or indirectly, on at least half the days of the person's taxable year by persons who are residents of the Contracting State of which that person is a resident and that are themselves entitled to treaty benefits under subparagraphs 2(a), 2(b), 2(d) or clause (i) of subparagraph 2(c). In the case of indirect owners, however, each of the intermediate owners must be a resident of that Contracting State.

Trusts may be entitled to benefits under this provision if they are treated as residents under Article 4 and they otherwise satisfy the requirements of this subparagraph. For purposes of this subparagraph, the beneficial interests in a trust will be considered to be owned by its beneficiaries in proportion to each beneficiary's actuarial interest in the trust. The interest of a remainder beneficiary will be equal to 100 percent less the aggregate percentages held by income beneficiaries. A beneficiary's interest in a trust will not be considered to be owned by a person entitled to benefits under subparagraphs 2(a), 2(b), 2(d) or clause (i) of subparagraph 2(c) if it is not possible to determine the beneficiary's actuarial interest. Consequently, if it is not possible to determine the actuarial interest of the beneficiaries in a trust, the ownership test under clause i) cannot be satisfied, unless all possible beneficiaries are persons entitled to benefits under subparagraphs 2(a), 2(b), 2(d) or clause (i) of subparagraph 2(c) .

The base erosion prong of clause (ii) of subparagraph 2(e) is satisfied with respect to a person if less than 50 percent of the person's gross income for the taxable year, as determined under the tax law in the person's State of residence, is paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State entitled to benefits under subparagraphs 2(a), 2(b), 2(d) or clause (i) of subparagraph 2(c), in the form of payments deductible for tax purposes in the payer's State of residence. These amounts do not include arm's-length payments in the ordinary course of business for services or tangible property, or payments in respect of financial obligations to a bank, provided that where such a bank is not a resident of a Contracting State, such payment is attributable to a permanent establishment of that bank located in one of the Contracting States. To the extent they are deductible from the taxable base, trust distributions are deductible payments. However, depreciation and amortization deductions, which do not represent payments or accruals to other persons, are disregarded for this purpose.

Paragraph 3

Paragraph 3 sets forth a derivative benefits test that is potentially applicable to all treaty benefits, although the test is applied to individual items of income. In general, a derivative benefits test entitles the resident of a Contracting State to treaty benefits if the owner of the resident would have been entitled to the same benefit had the income in question flowed directly to that owner. To qualify under this paragraph, the company must meet an ownership test and a base erosion test.

Clause (i) of subparagraph 3(a) sets forth the ownership test. Under this test, at least 95 percent of the aggregate voting power and value of the shares of the company must be owned by seven or fewer persons that are residents of Member States of the European Union, or of the European Economic Area, or parties to the North American Free Trade Agreement or the European Free Trade Agreement. Ownership may be direct or indirect. To be considered a resident of Member States of the European Union, or of the European Economic Area, or parties to the North American Free Trade Agreement or the European Free Trade Agreement for purposes of paragraph 3, a person must meet the requirements of subparagraph 3(b). These requirements may be met in two alternative ways.

Under one alternative, a person may be treated as a resident of Member States of the European Union, or of the European Economic Area, or parties to the North American Free Trade Agreement or the European Free Trade Agreement because it is entitled to equivalent benefits under a treaty between the country of source and the country in which the person is a resident. To satisfy this requirement, the person must be entitled to all the benefits of a comprehensive income tax convention in force between the Contracting State from which benefits of the Convention are claimed and a qualifying state under provisions that are analogous to the rules in subparagraphs 2(a), 2(b), 2(d) and clause (i) of subparagraph 2(c). If the treaty in question does not have a comprehensive limitation on benefits article, this requirement is met only if the person would be entitled to treaty benefits under the tests in subparagraphs 2(a), 2(b), 2(d) and clause (i) of subparagraph 2(c) of this Article if the person were a resident of one of the Contracting States.

In order to satisfy this alternative with respect to dividends, interest, royalties or branch tax, the person must be entitled to a rate of tax that is at least as low as the tax rate that would apply under the Convention to such income. Thus, the rates to be compared are: (1) the rate of tax that the source State would have imposed if a qualified resident of the other Contracting State was the beneficial owner of the income; and (2) the rate of tax that the source State would have imposed if the third State resident received the income directly from the source State. For example, USCo is a wholly owned subsidiary of IceCo, a company resident in Iceland. IceCo is wholly owned by CanCo, a corporation resident in Canada. Assuming IceCo satisfies the requirements of paragraph 2 of Article 10 (Dividends), IceCo would be eligible for a dividend withholding tax rate of 5 percent. The dividend withholding tax rate in the treaty between the United States and Canada is also 5 percent. Thus, if CanCo received the dividend directly from USCo, CanCo would have been subject to a 5 percent rate of withholding tax on the dividend. Because CanCo would be entitled to a rate of withholding tax that is at least as low as the rate that would apply under the Convention to such income, CanCo is treated as a resident of Member States of the European Union, or of the European Economic Area, or parties to the North American Free Trade Agreement or the European Free Trade Agreement with respect to the elimination of withholding tax on dividends.

The requirement that a person be entitled to "all the benefits" of a comprehensive tax treaty eliminates those persons that qualify for benefits with respect to only certain types of income. Accordingly, the fact that a Canadian parent of an Icelandic company is engaged in the active conduct of a trade or business in Canada and therefore would be entitled to the benefits of the U.S.-Canada treaty if it received dividends directly from a U.S. subsidiary of the Icelandic company is not sufficient for purposes of this paragraph. Further, the Canadian company cannot be an equivalent beneficiary if it qualifies for benefits only with respect to certain income as a result of a "derivative benefits" provision in the U.S.-Canada treaty.

However, it would be possible to look through the Canadian company to its parent company to determine whether the parent company is an equivalent beneficiary.

The second alternative requirement for treatment as a resident of Member States of the European Union, or of the European Economic Area, or parties to the North American Free Trade Agreement or the European Free Trade Agreement is available only to residents of one of the two Contracting States. U.S. or Icelandic residents who are eligible for treaty benefits by reason of subparagraphs 2(a), 2(b), 2(d) or clause (i) of subparagraph 2(c) are treated as residents of Member States of the European Union, or of the European Economic Area, or parties to the North American Free Trade Agreement or the European Free Trade Agreement under the second alternative. Thus, an Icelandic individual will qualify without regard to whether the individual would have been entitled to receive the same benefits if it received the income directly. A resident of a third country cannot qualify for treaty benefits under any of those subparagraphs or any other rule of the treaty, and therefore does not qualify under this alternative. Thus, a resident of a third country will be treated as a resident of Member States of the European Union, or of the European Economic Area, or parties to the North American Free Trade Agreement or the European Free Trade Agreement only if it would have been entitled to equivalent benefits had it received the income directly.

The second alternative was included in order to clarify that ownership by certain residents of a Contracting State would not disqualify a U.S. or Icelandic company under this paragraph. Thus, for example, if 90 percent of an Icelandic company is owned by five companies that are resident in member states of the European Union who satisfy the requirements of clause (ii), and 10 percent of the Icelandic company is owned by a U.S. or Icelandic individual, then the Icelandic company still can satisfy the requirements of subparagraph 3(b).

Clause (ii) of subparagraph 3(a) sets forth the base erosion test. A company meets this base erosion test if less than 50 percent of its gross income (as determined in the company's State of residence) for the taxable period is paid or accrued, directly or indirectly, to a person or persons who are not residents of Member States of the European Union, or of the European Economic Area, or parties to the North American Free Trade Agreement or the European Free Trade Agreement in the form of payments deductible for tax purposes in company's State of residence.

Paragraph 4

Paragraph 4 sets forth an alternative test under which a resident of a Contracting State may receive treaty benefits with respect to certain items of income that are connected to an active trade or business conducted in its State of residence. A resident of a Contracting State may qualify for benefits under paragraph 4 whether or not it also qualifies under paragraph 2 or 3.

Subparagraph 4(a) sets forth the general rule that a resident of a Contracting State engaged in the active conduct of a trade or business in that State may obtain the benefits of the Convention with respect to an item of income derived in the other Contracting State. The item of income, however, must be derived in connection with or incidental to that trade or business.

The term "trade or business" is not defined in the Convention. Pursuant to paragraph 2 of Article 3 (General Definitions), when determining whether a resident of Iceland is entitled to the benefits of the Convention under paragraph 3 of this Article with respect to an item of income derived from sources within the United States, the United States will ascribe to this

term the meaning that it has under the law of the United States. Accordingly, the U.S. competent authority will refer to the regulations issued under section 367(a) for the definition of the term "trade or business." In general, therefore, a trade or business will be considered to be a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit. Furthermore, a corporation generally will be considered to carry on a trade or business only if the officers and employees of the corporation conduct substantial managerial and operational activities.

The business of making or managing investments for the resident's own account will be considered to be a trade or business only when part of banking, insurance or securities activities conducted by a bank, an insurance company, or a registered securities dealer. Such activities conducted by a person other than a bank, insurance company or registered securities dealer will not be considered to be the conduct of an active trade or business, nor would they be considered to be the conduct of an active trade or business if conducted by a bank, insurance company or registered securities dealer but not as part of the company's banking, insurance or dealer business. Because a headquarters operation is in the business of managing investments, a company that functions solely as a headquarters company will not be considered to be engaged in an active trade or business for purposes of paragraph 3.

An item of income is derived in connection with a trade or business if the income-producing activity in the State of source is a line of business that "forms a part of" or is "complementary" to the trade or business conducted in the State of residence by the income recipient.

A business activity generally will be considered to form part of a business activity conducted in the State of source if the two activities involve the design, manufacture or sale of the same products or type of products, or the provision of similar services. The line of business in the State of residence may be upstream, downstream, or parallel to the activity conducted in the State of source. Thus, the line of business may provide inputs for a manufacturing process that occurs in the State of source, may sell the output of that manufacturing process, or simply may sell the same sorts of products that are being sold by the trade or business carried on in the State of source.

Example 1. USCo is a corporation resident in the United States. USCo is engaged in an active manufacturing business in the United States. USCo owns 100 percent of the shares of ICo, a corporation resident in Iceland. ICo distributes USCo products in Iceland. Since the business activities conducted by the two corporations involve the same products, ICo's distribution business is considered to form a part of USCo's manufacturing business.

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

For two activities to be considered to be "complementary," the activities need not relate to the same types of products or services, but they should be part of the same overall industry and be related in the sense that the success or failure of one activity will tend to result in success or failure for the other. Where more than one trade or business is conducted in the State of source and only one of the trades or businesses forms a part of or is complementary to a trade or

business conducted in the State of residence, it is necessary to identify the trade or business to which an item of income is attributable. Royalties generally will be considered to be derived in connection with the trade or business to which the underlying intangible property is attributable. Dividends will be deemed to be derived first out of earnings and profits of the treaty-benefited trade or business, and then out of other earnings and profits. Interest income may be allocated under any reasonable method consistently applied. A method that conforms to U.S. principles for expense allocation will be considered a reasonable method.

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

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

Example 5. USFlower is a corporation resident in the United States. USFlower produces and sells flowers in the United States and other countries. USFlower owns all the shares of IceHolding, a corporation resident in Iceland. IceHolding is a holding company that is not engaged in a trade or business. IceHolding owns all the shares of three corporations that are resident in Iceland: IceFlower, IceLawn, and IceFish. IceFlower distributes USFlower flowers under the USFlower trademark in Iceland. IceLawn markets a line of lawn care products in Iceland under the USFlower trademark. In addition to being sold under the same trademark, IceLawn and IceFlower products are sold in the same stores and sales of each company's products tend to generate increased sales of the other's products. IceFish imports fish from the United States and distributes it to fish wholesalers in Iceland. For purposes of paragraph 3, the business of IceFlower forms a part of the business of USFlower, the business of IceLawn is complementary to the business of USFlower, and the business of IceFish is neither part of nor complementary to that of USFlower.

An item of income derived from the State of source is "incidental to" the trade or business carried on in the State of residence if production of the item facilitates the conduct of the trade or business in the State of residence. An example of incidental income is the temporary investment of working capital of a person in the State of residence in securities issued by persons in the State of source.

Subparagraph 4(b) states a further condition to the general rule in subparagraph 4(a) in cases where the trade or business generating the item of income in question is carried on either by the person deriving the income or by any associated enterprises. Subparagraph 4(b) states that the trade or business carried on in the State of residence, under these circumstances, must be substantial in relation to the activity in the State of source. The substantiality requirement is intended to prevent a narrow case of treaty-shopping abuses in which a company attempts to

qualify for benefits by engaging in de minimis connected business activities in the treaty country in which it is resident (*i.e.*, activities that have little economic cost or effect with respect to the company business as a whole).

The determination of substantiality is made based upon all the facts and circumstances and takes into account the comparative sizes of the trades or businesses in each Contracting State the nature of the activities performed in each Contracting State, and the relative contributions made to that trade or business in each Contracting State.

The determination in subparagraph 4(b) also is made separately for each item of income derived from the State of source. It therefore is possible that a person would be entitled to the benefits of the Convention with respect to one item of income but not with respect to another. If a resident of a Contracting State is entitled to treaty benefits with respect to a particular item of income under paragraph 3, the resident is entitled to all benefits of the Convention insofar as they affect the taxation of that item of income in the State of source.

Subparagraph 4(c) provides special attribution rules for purposes of applying the substantive rules of subparagraph 4(a). Thus, these rules apply for purposes of determining whether a person meets the requirement in subparagraph 4(a) that it be engaged in the active conduct of a trade or business and that the item of income is derived in connection with that active trade or business. Subparagraph 4(c) attributes to a person activities conducted by a partnership in which that person is a partner and activities conducted by persons "connected" to such person. A person ("X") is connected to another person ("Y") if X possesses 50 percent or more of the beneficial interest in Y (or if Y possesses 50 percent or more of the beneficial interest in X). For this purpose, X is connected to a company if X owns shares representing fifty percent or more of the aggregate voting power and value of the company or fifty percent or more of the beneficial equity interest in the company. X also is connected to Y if a third person possesses, directly or indirectly, fifty percent or more of the beneficial interest in both X and Y. For this purpose, if X or Y is a company, the threshold relationship with respect to such company or companies is fifty percent or more of the aggregate voting power and value or fifty percent or more of the beneficial equity interest. Finally, X is connected to Y if, based upon all the facts and circumstances, X controls Y, Y controls X, or X and Y are controlled by the same person or persons.

Paragraph 5

Paragraph 5 deals with the treatment of income in the context of a so-called "triangular case."

The term "triangular case" refers to the use of the following structure by a resident of Iceland to earn, in this case, interest income from the United States. The resident of Iceland, who is assumed to qualify for benefits under one or more of the provisions of Article 16 (Limitation on Benefits), sets up a permanent establishment in a third jurisdiction that imposes only a low rate of tax on the income of the permanent establishment. The Icelandic resident lends funds into the United States through the permanent establishment. The permanent establishment, despite its third-jurisdiction location, is an integral part of a Icelandic resident. Therefore the income that it earns on those loans, absent the provisions of paragraph 5, is entitled to exemption from U.S. withholding tax under the Convention. Under a current Icelandic income tax treaty with the host jurisdiction of the permanent establishment, the income of the permanent establishment is exempt from Icelandic tax (alternatively, Iceland may choose to exempt the income of the permanent establishment from Icelandic income tax). Thus, the interest income is exempt from

U.S. tax, is subject to little tax in the host jurisdiction of the permanent establishment, and is exempt from Icelandic tax.

Paragraph 5 applies reciprocally. However, the United States does not exempt the profits of a third-jurisdiction permanent establishment of a U.S. resident from U.S. tax, either by statute or by treaty.

Paragraph 5 provides that the tax benefits that would otherwise apply under the Convention will not apply to any item of income if the combined tax actually paid in the residence State and the third state is less than 60 percent of the tax that would have been payable in the residence State if the income were earned in that State by the enterprise and were not attributable to the permanent establishment in the third state. In the case of dividends, interest and royalties to which this paragraph applies, the withholding tax rates under the Convention are replaced with a 15 percent withholding tax. Any other income to which the provisions of paragraph 5 apply is subject to tax under the domestic law of the source State, notwithstanding any other provisions of the Convention.

In general, the principles employed under Code section 954(b)(4) will be employed to determine whether the profits are subject to an effective rate of taxation that is above the specified threshold.

Notwithstanding the level of tax on interest and royalty income of the permanent establishment, paragraph 5 will not apply under certain circumstances. In the case of royalties, paragraph 5 will not apply if the royalties are received as compensation for the use of, or the right to use, intangible property produced or developed by the permanent establishment itself. In the case of any other income, paragraph 5 will not apply if that income is derived in connection with, or is incidental to, the active conduct of a trade or business carried on by the permanent establishment in the third state. The business of making, managing or simply holding investments is not considered to be an active trade or business, unless these are banking or securities activities carried on by a bank or registered securities dealer.

Paragraph 6

Paragraph 6 provides a special rule where a company resident in a Contracting State, or a company that controls such a company directly or indirectly, has a class of shares that is subject to terms or other arrangements that entitle the holder to a larger portion of the company's income than the portion the holders would receive absent such terms or arrangements ("the disproportionate part of the income"). Where 50 percent or more of such a class of shares is owned by persons who are not entitled to benefits under paragraph 2, the benefits of the Convention shall not apply with respect to the disproportionate part of the income of the Company.

The following example illustrates this result.

Example. IceCo is a corporation resident in Iceland. IceCo has two classes of shares: Common and Preferred. The Common shares are listed and regularly traded on the Icelandic Stock Exchange. The Preferred shares have no voting rights and are entitled to receive dividends equal in amount to interest payments that IceCo receives from unrelated borrowers in the United States. The Preferred shares are owned entirely by a single investor that is a resident of a third country. The Common shares account for more than 50 percent of the value of IceCo and for 100 percent of the voting power. Because the owner of the Preferred shares is entitled to receive

payments corresponding to the U.S. source interest income earned by IceCo, the Preferred shares are a disproportionate class of shares. Because the Preferred shares are not owned by persons entitled to benefits under paragraph 2, the benefits of the Convention shall not apply with respect to IceCo's U.S.-source interest income.

Paragraph 7

Paragraph 7 provides that a resident of one of the States that is not entitled to the benefits of the Convention as a result of paragraphs 1 through 5 still shall be granted benefits under the Convention if the competent authority of the State from which benefits are claimed determines that the establishment, acquisition, or maintenance of the person seeking benefits under the Convention, or the conduct of such person's operations, has or had as one of its principal purposes the obtaining of benefits under the Convention. Benefits will not be granted, however, solely because a company was established prior to the effective date of a treaty or protocol. In that case a company would still be required to establish, to the satisfaction of the competent authority, clear non-tax business reasons for its formation in a Contracting State, or that the allowance of benefits would not otherwise be contrary to the purposes of the treaty. Thus, persons that establish operations in one of the States with a principal purpose of obtaining the benefits of the Convention ordinarily will not be granted relief under paragraph 7.

The competent authority's discretion is quite broad. It may grant all of the benefits of the Convention to the taxpayer making the request, or it may grant only certain benefits. For instance, it may grant benefits only with respect to a particular item of income in a manner similar to paragraph 3. Further, the competent authority may establish conditions, such as setting time limits on the duration of any relief granted.

For purposes of implementing paragraph 7, a taxpayer will be permitted to present his case to the relevant competent authority for an advance determination based on the facts. In these circumstances, it is also expected that, if the competent authority determines that benefits are to be allowed, they will be allowed retroactively to the time of entry into force of the relevant treaty provision or the establishment of the structure in question, whichever is later.

Finally, there may be cases in which a resident of a Contracting State may apply for discretionary relief to the competent authority of his State of residence. This would arise, for example, if the benefit it is claiming is provided by the residence country, and not by the source country. So, for example, if a company that is a resident of the United States would like to claim the benefit of the re-sourcing rule of subparagraph 2(a) of Article 22, but it does not meet any of the objective tests of paragraphs 2 through 5, it may apply to the U.S. competent authority for discretionary relief.

Paragraph 8

Paragraph 8 defines several key terms for purposes of Article 22. Each of the defined terms is discussed above in the context in which it is used.

ARTICLE 22 (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 under its internal law, and by treaty.

Paragraph 1

The United States agrees, in paragraph 1, to allow to its citizens and residents a credit against U.S. tax for income taxes paid or accrued to Iceland. Paragraph 1 also provides that Iceland's covered taxes are income taxes for U.S. purposes. This provision is based on the Treasury Department's review of Iceland's laws.

Subparagraph 1(b) provides for a deemed-paid credit, consistent with section 902 of the Code, to a U.S. corporation in respect of dividends received from a corporation resident in Iceland of which the U.S. corporation owns at least 10 percent of the voting stock. This credit is for the tax paid by the corporation to Iceland on the profits out of which the dividends are considered paid.

The [illegible]edits allowed under paragraph 1 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 the Article, that is, 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 provisio[illegible] time a credit is given, of the U.S. statutory credit.

[illegible]e, the U.S. credit under the Convention is subject to the various limitations of U[illegible]aw [illegible]g., Code sections 901-908). For example, the credit against U.S. tax generally is [illegible]ited [illegible] amount of U.S. tax due with respect to net foreign source income within the relev[illegible]gn tax credit limitation category (see Code section 904(a) and (d)), and the dollar [illegible]nt [illegible]redit is determined in accordance with U.S. currency translation rules (see, *e.g.*, [illegible]on 986 [illegible] .S. law applies to determine carryover periods for excess credits [illegible] inter-year [illegible]ts.

[illegible] 2

Paragraph [illegible]rcing rule for gross income covered by paragraph 1. Su[illegible]paragraph 2(a) [illegible]nsure that a U.S. resident can obtain an appropriate amount of U.S. foreign tax cr[illegible]es paid to Iceland when the Convention assigns to Iceland p[illegible]ary taxing rig[illegible] gross income.

Accordingly [illegible] Convention allows Iceland to tax an item of gross income (as defined under U.S. law) d[illegible]ved by a re[illegible]ident of the United States, the United States will treat that item of gross income as gross income from sources within Iceland for U.S. foreign tax credit purposes. In the case of [illegible].S.-owned foreign corporation, however, section 904(g)(10) may ap[illegible] for purposes of determining the U.S. foreign tax credit with respect to income subject to this re-sourcing rule. Section 904(g)(10) generally applies the foreign tax credit limitation separately to re-sourced income. Furthermore, the subparagraph 2(a) re-sourcing rule applies to gross income, not net income. Accordingly, U.S. expense allocation and apportionment rules, see, *e.g.*, Treas. Reg. section 1.861-9, continue to apply to income resourced under subparagraph 2(a).

Subparagraph 2(b) provides that gains derived by an individual who was a resident of the United States that are taxed by the United States in accordance with the Convention, and that may also be taxed in Iceland solely by reason of Article 13 (Capital Gains), shall be deemed to be gains from sources in the United States. The provisions of subparagraph 2(b) ensure that the United States does not bear, from a foreign tax credit standpoint, the cost of Iceland's expatriation tax.

Paragraph 3

Specific rules are provided in paragraph 3 under which Iceland, in imposing tax on its residents, provides relief for U.S. taxes paid by those residents. Subparagraph 3(a) provides that when a resident of Iceland derives income that, in accordance with the provisions of the Convention, may be taxed in the United States, Iceland shall allow as a credit against Icelandic income taxes an amount equal to those taxes paid to the United States.

Subparagraph 3(b) limits the credits against Icelandic taxes to those taxes that are attributable to the income that has been taxed by the United States.

Subparagraph 3(c) provides that when a resident of Iceland derives income that, in accordance with the provisions of the Convention, may be taxed by the United States, Iceland shall allow the credit against Icelandic tax described in subparagraph 3(b). However, subparagraph 3(c) also permits Iceland to include the income corresponding to the U.S. tax in the resident's tax base for purposes of determining the Icelandic tax. This rule is a variation of the "exemption with progression rule," adapted to accommodate Iceland's credit system. It is also similar to U.S. domestic law, which permits credits for foreign taxes paid, while at the same time taxing residents on worldwide income. Finally, subparagraph 3(c) provides that for purposes of this Article, the U.S. taxes referred to in subparagraph 3(b) and paragraph 4 of Article 2 (Taxes Covered) are considered to be income taxes and are allowed as credits against Icelandic tax on income, subject to all of the provisions and limitations of this paragraph.

Paragraph 4

Paragraph 4 provides special rules for the tax treatment in both States of certain types of income derived from U.S. sources by U.S. citizens who are residents of Iceland. Since U.S. citizens, regardless of residence, 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 Iceland may exceed the U.S. tax that may be imposed under the Convention on an item of U.S. source income derived by a resident of Iceland who is not a U.S. citizen. The provisions of paragraph 4 ensure that Iceland does not bear the cost of U.S. taxation of its citizens who are residents of Iceland.

Subparagraph 4(a) provides, with respect to items of income from sources within the United States, special credit rules for Iceland. These rules apply to items of U.S.-source income that would be either exempt from U.S. tax or subject to reduced rates of U.S. tax under the provisions of the Convention if they had been received by a resident of Iceland who is not a U.S. citizen. The tax credit allowed under paragraph 4 with respect to such items need not exceed the U.S. tax that may be imposed under the Convention, other than tax imposed solely by reason of the U.S. citizenship of the taxpayer under the provisions of the saving clause of paragraph 4 of Article 1 (General Scope).

For example, if a U.S. citizen resident in Iceland receives portfolio dividends from sources within the United States, the foreign tax credit granted by Iceland would be limited to 15 percent of the dividend – the U.S. tax that may be imposed under subparagraph 2(b) of Article 10 (Dividends) – even if the shareholder is subject to U.S. net income tax because of his U.S. citizenship. With respect to interest income, Iceland would allow no foreign tax credit, because its residents are exempt from U.S. tax on interest income under the provisions of Articles 11 (Interest).

Subparagraph 4(b) eliminates the potential for double taxation that can arise because subparagraph 4(a) provides that Iceland need not provide full relief for the U.S. tax imposed on its citizens resident in Iceland. The subparagraph provides that the United States will credit the income tax paid or accrued to Iceland, after the application of subparagraph 4(a). It further provides that in allowing the credit, the United States will not reduce its tax below the amount that is taken into account in Iceland in applying subparagraph 4(a).

Since the income described in subparagraph 4(a) generally will be U.S. source income, special rules are required to re-source some of the income to Iceland in order for the United States to be able to credit the tax paid to Iceland. This re-sourcing is provided for in subparagraph 4(c), which deems the items of income referred to in subparagraph 4(a) to be from foreign sources to the extent necessary to avoid double taxation under subparagraph 4(b). Clause (iii) of subparagraph 3(c) of Article 24 (Mutual Agreement Procedure) provides a mechanism by which the competent authorities can resolve any disputes regarding whether income is from sources within the United States.

The following two examples illustrate the application of paragraph 4 in the case of a U.S.-source portfolio dividend received by a U.S. citizen resident in Iceland. In both examples, the U.S. rate of tax on residents of Iceland, under subparagraph 2(b) of Article 10 (Dividends) of the Convention, is 15 percent. In both examples, the U.S. income tax rate on the U.S. citizen is 35 percent. In example 1, the rate of income tax imposed in Iceland on its resident (the U.S. citizen) is 25 percent (below the U.S. rate), and in example 2, the rate imposed on its resident is 40 percent (above the U.S. rate).

	Example 1	Example 2
Subparagraph (a)		
U.S. dividend declared	$100.00	$100.00
Notional U.S. withholding tax (Article 10(2)(b))	15.00	15.00
Taxable income in Iceland	100.00	100.00
Icelandic tax before credit	25.00	40.00
Less: tax credit for notional U.S. withholding tax	15.00	15.00
Net post-credit tax paid to Iceland	10.00	25.00
Subparagraphs (b) and (c)		
U.S. pre-tax income	$100.00	$100.00
U.S. pre-credit citizenship tax	35.00	35.00
Notional U.S. withholding tax	15.00	15.00
U.S. tax eligible to be offset by credit	20.00	20.00
Tax paid to Iceland	10.00	25.00
Income re-sourced from U.S. to foreign source (see below)	28.57	57.14
U.S. pre-credit tax on re-sourced income	10.00	20.00
U.S. credit for tax paid to Iceland	10.00	20.00
Net post-credit U.S. tax	10.00	0.00
Total U.S. tax	25.00	15.00

In both examples, in the application of subparagraph 4(a), Iceland credits a 15 percent U.S. tax against its residence tax on the U.S. citizen. In the first example, the net tax paid to Iceland after the foreign tax credit is $10.00; in the second example, it is $25.00. In the

application of subparagraphs 4(b) and 4(c), from the U.S. tax due before credit of $35.00, the United States subtracts the amount of the U.S. source tax of $15.00, against which no U.S. foreign tax credit is allowed. This subtraction ensures that the United States collects the tax that it is due under the Convention as the State of source.

In both examples, given the 35 percent U.S. tax rate, the maximum amount of U.S. tax against which credit for the tax paid to Iceland may be claimed is $20 ($35 U.S. tax minus $15 U.S. withholding tax). Initially, all of the income in both examples was from sources within the United States. For a U.S. foreign tax credit to be allowed for the full amount of the tax paid to Iceland, an appropriate amount of the income must be re-sourced to Iceland under subparagraph 4(c).

The amount that must be re-sourced depends on the amount of tax for which the U.S. citizen is claiming a U.S. foreign tax credit. In example 1, the tax paid to Iceland was $10. For this amount to be creditable against U.S. tax, $28.57 ($10 tax divided by 35 percent U.S. tax rate) must be resourced to Iceland. When the tax is credited against the $10 of U.S. tax on this resourced income, there is a net U.S. tax of $10 due after credit ($20 U.S. tax eligible to be offset by credit, minus $10 tax paid to Iceland). Thus, in example 1, there is a total of $25 in U.S. tax ($15 U.S. withholding tax plus $10 residual U.S. tax).

In example 2, the tax paid to Iceland was $25, but, because the United States subtracts the U.S. withholding tax of $15 from the total U.S. tax of $35, only $20 of U.S. taxes may be offset by taxes paid to Iceland. Accordingly, the amount that must be resourced to Iceland is limited to the amount necessary to ensure a U.S. foreign tax credit for $20 of tax paid to Iceland, or $57.14 ($20 tax paid to Iceland divided by 35 percent U.S. tax rate). When the tax paid to Iceland is credited against the U.S. tax on this re-sourced income, there is no residual U.S. tax ($20 U.S. tax minus $25 tax paid to Iceland, subject to the U.S. limit of $20). Thus, in example 2, there is a total of $15 in U.S. tax ($15 U.S. withholding tax plus $0 residual U.S. tax). Because the tax paid to Iceland was $25 and the U.S. tax eligible to be offset by credit was $20, there is $5 of excess foreign tax credit available for carryover.

Relationship to other Articles

By virtue of subparagraph 5(a) of Article 1 (General Scope), Article 22 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 (such as the re-sourcing provided by paragraph 2 and subparagraph 4(c)).

ARTICLE 23 (NON-DISCRIMINATION)

This Article ensures that nationals 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, directly or indirectly, to discriminatory taxation in the other Contracting State. Not all differences in tax treatment, either as between nationals of the two States, or between residents of the two States, are violations of the prohibition against discrimination. Rather, the non-discrimination obligations of this Article apply only if the nationals or residents of the two States are comparably situated.

Each of the relevant paragraphs of the Article provides that two persons that are comparably situated must be treated similarly. Although the actual words differ from paragraph

to paragraph (*e.g.*, paragraph 1 refers to two nationals "in the same circumstances," paragraph 2 refers to two enterprises "carrying on the same activities" and paragraph 4 refers to two enterprises that are "similar"), the common underlying premise is that if the difference in treatment is directly related to a tax-relevant difference in the situations of the domestic and foreign persons being compared, that difference is not to be treated as discriminatory (i.e., if one person is taxable in a Contracting State on worldwide income and the other is not, or tax may be collectible from one person at a later stage, but not from the other, distinctions in treatment would be justified under paragraph 1). Other examples of such factors that can lead to non-discriminatory differences in treatment are noted in the discussions of each paragraph.

The operative paragraphs of the Article also use different language to identify the kinds of differences in taxation treatment that will be considered discriminatory. For example, paragraphs 1 and 4 speak of "any taxation or any requirement connected therewith that is more burdensome," while paragraph 2 specifies that a tax "shall not be less favorably levied." Regardless of these differences in language, only differences in tax treatment that materially disadvantage the foreign person relative to the domestic person are properly the subject of the Article.

Paragraph 1

Paragraph 1 provides that a national 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 national of that other State in the same circumstances.

The term "national" in relation to a Contracting State is defined in subparagraph 1(j) of Article 3 (General Definitions). The term includes both individuals and juridical persons. 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 Iceland as a national of Iceland who is in similar circumstances (i.e., presumably one who is resident in a third State).

As noted above, whether or not the two persons are both taxable on worldwide income is a significant circumstance for this purpose. For this reason, paragraph 1 specifically states that the United States is not obligated to apply the same taxing regime to a national of Iceland who is not resident in the United States as it applies to a U.S. national who is not resident in the United States. 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 Iceland who are not United States residents. Thus, for example, Article 23 would not entitle a national of Iceland resident in a third country to taxation at graduated rates on U.S. source dividends or other investment income that applies to a U.S. citizen resident in the same third country.

Paragraph 2

Paragraph 2 of the Article, provides that a Contracting State may not tax a permanent establishment of an enterprise of the other Contracting State less favorably than an enterprise of that first-mentioned State that is carrying on the same activities.

The fact that a U.S. permanent establishment of an enterprise of Iceland is subject to U.S. tax only on income that is attributable to the permanent establishment, while a U.S. corporation

engaged in the same activities is taxable on its worldwide income is not, in itself, a sufficient difference to provide different treatment for the permanent establishment. There are cases, however, where the two enterprises would not be similarly situated and differences in treatment may be warranted. For instance, it would not be a violation of the non-discrimination protection of paragraph 2 to require the foreign enterprise to provide information in a reasonable manner that may be different from the information requirements imposed on a resident enterprise, because information may not be as readily available to the Internal Revenue Service from a foreign as from a domestic enterprise. Similarly, it would not be a violation of paragraph 2 to impose penalties on persons who fail to comply with such a requirement (see, *e.g.*, sections 874(a) and 882(c)(2)). Further, a determination that income and expenses have been attributed or allocated to a permanent establishment in conformity with the principles of Article 7 (Business Profits) implies that the attribution or allocation was not discriminatory.

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 share of the partnership income of a partner resident in Iceland, and attributable to a U.S. permanent establishment. There is no similar obligation with respect to the distributive shares of U.S. resident partners. It is understood, however, that this distinction is not a form of discrimination within the meaning of paragraph 2 of the Article. No distinction is made between U.S. and non-U.S. partnerships, since the law requires that partnerships of both U.S. and non-U.S. domicile withhold tax in respect of the partnership shares of non-U.S. partners. Furthermore, in distinguishing between U.S. and non-U.S. partners, the requirement to withhold on the non-U.S. but not the U.S. partner's share is not discriminatory taxation, but, like other withholding on nonresident aliens, is merely a reasonable method for the collection of tax from persons who are not continually present in the United States, and as to whom it otherwise may be difficult for the United States to enforce its tax jurisdiction. If tax has been over-withheld, the partner can, as in other cases of over-withholding, file for a refund.

Paragraph 2 does not obligate a Contracting State to grant to a resident of the other Contracting State any tax allowances, reliefs, etc., that it grants to its own residents on account of their civil status or family responsibilities. Thus, if a sole proprietor who is a resident of Iceland 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 resident of Iceland the personal allowances for himself and his family that he would be permitted to take if the permanent establishment were a sole proprietorship owned and operated by a U.S. resident, despite the fact that the individual income tax rates would apply.

Paragraph 3

Paragraph 3 prohibits discrimination in the allowance of deductions. When a resident or an enterprise of a Contracting State pays interest, royalties or 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 resident or enterprise as if the payment had been made under the same conditions to a resident of the first-mentioned Contracting State. Paragraph 3, however, does not require a Contracting State to give nonresidents more favorable treatment than it gives to its own residents. Consequently, a Contracting State does not have to allow nonresidents a deduction for items that are not deductible under its domestic law (for example, expenses of a capital nature).

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.

An exception to the rule of paragraph 3 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. All of these provisions permit the denial of deductions in certain circumstances in respect of transactions between related persons. Neither State is forced to apply the non-discrimination principle in such cases. The exception with respect to paragraph 4 of Article 11 would include the denial or deferral of certain interest deductions under Code section 163(j).

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-mentioned Contracting State for purposes of 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. Even though, for general purposes, the Convention covers only income taxes, under paragraph 6 of this Article, the nondiscrimination provisions apply to all taxes levied in both Contracting States, at all levels of government.

Paragraph 4

Paragraph 4 requires that a Contracting State not impose more burdensome taxation or connected requirements on 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 than the taxation or connected requirements that it imposes on other similar enterprises of that first-mentioned Contracting State. For this purpose it is understood that "similar" refers to similar activities or ownership of the enterprise.

This rule, like all non-discrimination provisions, does not prohibit differing treatment of entities that are in differing circumstances. Rather, a protected enterprise is only required to be treated in the same manner as other enterprises that, from the point of view of the application of the tax law, are in substantially similar circumstances both in law and in fact. The taxation of a distributing corporation under section 367(e) on an applicable distribution to foreign shareholders does not violate paragraph 4 of the Article because a foreign-owned corporation is not similar to a domestically-owned corporation that is accorded non-recognition treatment under sections 337 and 355.

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 5 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, 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 the protections of conducting 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. Similarly, the provisions 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 provision to permit individuals to conduct a business in corporate form at individual tax rates would not be furthered by their inclusion.

Finally, it is understood that paragraph 4 does not require a Contracting State to allow foreign corporations to join in filing a consolidated return with a domestic corporation or to allow similar benefits between domestic and foreign enterprises.

Paragraph 5

Paragraph 5 of the Article confirms that no provision of the Article will prevent either Contracting State from imposing the branch profits tax described in paragraph 8 of Article 10 (Dividends).

Paragraph 6

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

Relationship to Other Articles

The saving clause of paragraph 4 of Article 1 (General Scope) does not apply to this Article by virtue of the exceptions in subparagraph 5(a) of Article 1. Thus, for example, a U.S. citizen who is a resident of Iceland may claim benefits in the United States under this Article.

Nationals of a Contracting State may claim the benefits of paragraph 1 regardless of whether they are entitled to benefits under Article 21 (Limitation on Benefits), because that paragraph applies to nationals and not residents. They may not claim the benefits of the other paragraphs of this Article with respect to an item of income unless they are generally entitled to treaty benefits with respect to that income under a provision of Article 21.

ARTICLE 24 (MUTUAL AGREEMENT PROCEDURE)

This Article provides the mechanism for taxpayers to bring to the attention of competent authorities issues and problems that may arise under the Convention. It also provides the authority for cooperation between the competent authorities of the Contracting States to resolve disputes and clarify issues 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

This paragraph provides that where a resident of a Contracting State considers that the actions of one or both Contracting States will result in taxation that is not in accordance with the

Convention, he may present his case to the competent authority of either Contracting State. This rule is more generous than in most treaties, which generally allow taxpayers to bring competent authority cases only to the competent authority of their country of residence, or citizenship/nationality. Under this more generous rule, a U.S. permanent establishment of a corporation resident in Iceland that faces inconsistent treatment in the two countries would be able to bring its request for assistance to the U.S. competent authority. If the U.S. competent authority can resolve the issue on its own, then the taxpayer need never involve the Icelandic competent authority. Thus, the rule provides flexibility that might result in greater efficiency.

Although the typical cases brought under this paragraph will involve economic double taxation arising from transfer pricing adjustments, the scope of this paragraph is not limited to such cases. For example, a taxpayer could request assistance from the competent authority if one Contracting State determines that the taxpayer has received deferred compensation taxable at source under Article 14 (Income from Employment), while the taxpayer believes that such income should be treated as a pension that is taxable only in his country of residence pursuant to Article 17 (Pensions, Social Security, and Annuities).

It is not necessary for a person requesting assistance first to have exhausted the remedies provided under the national laws of the Contracting States before presenting a case to the competent authorities, nor does the fact that the statute of limitations may have passed for seeking a refund preclude bringing a case to the competent authority. Unlike the OECD Model, no time limit is provided within which a case must be brought.

Paragraph 2

Paragraph 2 sets out the framework within which the competent authorities will deal with cases brought by taxpayers under paragraph 1. It provides that, if the competent authority of the Contracting State to which the case is presented judges the case to have merit, and cannot reach a unilateral solution, it shall seek an agreement with the competent authority of the other Contracting State pursuant to which taxation not in accordance with the Convention will be avoided.

Any agreement is to be implemented even if such implementation otherwise would be barred by the statute of limitations or by some other procedural limitation, such as a closing agreement. Paragraph 2, however, does not prevent the application of domestic-law procedural limitations that give effect to the agreement (*e.g.*, a domestic-law requirement that the taxpayer file a return reflecting the agreement within one year of the date of the agreement).

Where the taxpayer has entered a closing agreement (or other written settlement) with the United States before bringing a case to the competent authorities, the U.S. competent authority will endeavor only to obtain a correlative adjustment from Iceland. *See* Rev. Proc. 2006-54, 2006-49 I.R.B. 1035, § 7.05. Because, as specified in paragraph 2 of Article 1 (General Scope), the Convention cannot operate to increase a taxpayer's liability, temporal or other procedural limitations can be overridden only for the purpose of making refunds and not to impose additional tax.

Paragraph 3

Paragraph 3 authorizes the competent authorities 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. This list is purely illustrative; it does not grant any authority that is not implicitly present as a result of the introductory sentence of paragraph 3.

The competent authorities may, for example, agree to the same allocation of income, deductions, credits or allowances between an enterprise in one Contracting State and its permanent establishment in the other or between related persons. These allocations are to be made in accordance with the arm's length principle underlying Article 7 (Business Profits) and Article 9 (Associated Enterprises). Agreements reached under these subparagraphs may include agreement on a methodology for determining an appropriate transfer price, on an acceptable range of results under that methodology, or on a common treatment of a taxpayer's cost sharing arrangement.

As indicated in subparagraphs 3(a) through 3(f), the competent authorities also may agree to settle a variety of conflicting applications of the Convention. They may agree to settle conflicts regarding the characterization of particular items of income, including the same characterization of income that is assimilated to income from shares by the taxation law of one of the Contracting States and that is treated as a different class of income in the other State. They may also agree to the characterization of persons, the application of source rules to particular items of income, the meaning of a term, or the timing of an item of income.

The competent authorities also may agree as to the application of the provisions of domestic law regarding penalties, fines, and interest in a manner consistent with the purposes of the Convention.

Since the list under paragraph 3 is not exhaustive, the competent authorities may reach agreement on issues not enumerated in paragraph 3 if necessary to avoid double taxation. For example, the competent authorities may seek agreement on a uniform set of standards for the use of exchange rates. Agreements reached by the competent authorities under paragraph 3 need not conform to the internal law provisions of either Contracting State.

Finally, paragraph 3 authorizes the competent authorities to consult for the purpose of eliminating double taxation in cases not provided for in the Convention and to resolve any difficulties or doubts arising as to the interpretation or application of the Convention. This provision is intended to permit the competent authorities to implement the treaty in particular cases in a manner that is consistent with its expressed general purposes. It permits the competent authorities to deal with cases that are within the spirit of the provisions but that are not specifically covered. 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 Iceland. Since no resident of a Contracting State is involved in the case, the Convention does not apply, but the competent authorities nevertheless may use the authority of this Article to prevent the double taxation of income.

Paragraph 4

Paragraph 4 provides that the competent authorities may communicate with each other for the purpose of reaching an agreement. This makes clear that the competent authorities of the two Contracting States may communicate without going through diplomatic channels. Such communication may be in various forms, including, where appropriate, through face-to-face meetings of representatives of the competent authorities.

Treaty termination in relation to competent authority dispute resolution

A case may be raised by a taxpayer after the Convention has been terminated with respect to a year for which a treaty was in force. In such a case the ability of the competent authorities to act is limited. They may not exchange confidential information, nor may they reach a solution that varies from that specified in its law.

Triangular competent authority solutions

International tax cases may involve more than two taxing jurisdictions (e.g., transactions among a parent corporation resident in country A and its subsidiaries resident in countries B and C). As long as there is a complete network of treaties among the three countries, it should be possible, under the full combination of bilateral authorities, for the competent authorities of the three States to work together on a three-sided solution. Although country A may not be able to give information received under Article 26 (Exchange of Information and Administrative Assistance) from country B to the authorities of country C, if the competent authorities of the three countries are working together, it should not be a problem for them to arrange for the authorities of country B to give the necessary information directly to the tax authorities of country C, as well as to those of country A. Each bilateral part of the trilateral solution must, of course, not exceed the scope of the authority of the competent authorities under the relevant bilateral treaty.

Relationship to Other Articles

This Article is not subject to the saving clause of paragraph 4 of Article 1 (General Scope) by virtue of the exceptions in subparagraph 5(a) of that Article. Thus, rules, definitions, procedures, etc. that are agreed upon by the competent authorities under this Article may be applied by the United States with respect to its citizens and residents even if they differ from the comparable Code provisions. Similarly, as indicated above, U.S. law may be overridden to provide refunds of tax to a U.S. citizen or resident under this Article. A person may seek relief under Article 24 regardless of whether he is generally entitled to benefits under Article 21 (Limitation on Benefits). As in all other cases, the competent authority is vested with the discretion to decide whether the claim for relief is justified.

ARTICLE 25 (EXCHANGE OF INFORMATION AND ADMINISTRATIVE ASSISTANCE)

This Article provides for the exchange of information and administrative assistance between the competent authorities of the Contracting States.

Paragraph 1

The obligation to obtain and provide information to the other Contracting State is set out in paragraph 1. The information to be exchanged is that which is relevant for carrying out the provisions of the Convention or the domestic laws of the United States or of the Iceland concerning taxes of every kind applied at the national level. Exchange of information with respect to each State's domestic law is authorized to the extent that taxation under domestic law 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 to carry out the Convention. An example of such a case is provided in the OECD Commentary: a company

resident in the United States and a company resident in Iceland transact business between themselves through a third-country resident company. Neither Contracting State has a treaty with the third State. To enforce their internal laws with respect to transactions of their residents with the third-country company (since there is no relevant treaty in force), the Contracting States may exchange information regarding the prices that their residents paid in their transactions with the third-country resident.

Paragraph 1 clarifies that information may be exchanged that relates to the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. Thus, the competent authorities may request and provide information for cases under examination or criminal investigation, in collection, on appeals, or under prosecution.

The taxes covered by the Convention for purposes of this Article constitute a broader category of taxes than those referred to in Article 2 (Taxes Covered). Exchange of information is authorized with respect to taxes of every kind imposed by a Contracting State at the national level. Accordingly, information may be exchanged with respect to U.S. estate and gift taxes, excise taxes or, with respect to Iceland, value added taxes.

Information exchange is not restricted by paragraph 1 of Article 1 (General Scope). Accordingly, 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 Iceland, and that permanent establishment engages in transactions with a U.S. enterprise, the United States could request information with respect to that permanent establishment, even though the third-country resident is not a resident of either Contracting State. Similarly, if a third-country resident maintains a bank account in Iceland, 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 Iceland with respect to that person's account, even though that person is not the taxpayer under examination.

Although the term "United States" does not encompass U.S. possessions for most purposes of the Convention, Section 7651 of the Code authorizes the Internal Revenue Service to utilize the provisions of the Internal Revenue Code to obtain information from the U.S. possessions pursuant to a proper request made under Article 25. If necessary to obtain requested information, the Internal Revenue Service could issue and enforce an administrative summons to the taxpayer, a tax authority (or a government agency in a U.S. possession), or a third party located in a U.S. possession.

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, involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of the of appeals in relation to, the taxes covered by the Convention. The information must be used by these persons in connection with the specified functions. Information may also be disclosed to legislative bodies, such as the tax-writing committees of Congress and the Government Accountability Office, engaged in the oversight of the preceding activities. Information received by these bodies must be 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.

Paragraph 2

Paragraph 2 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. In the absence of such a paragraph, some taxpayers have argued that subparagraph 3(a) prevents a Contracting State from requesting information from a bank or fiduciary that the Contracting State does not need for its own tax purposes. This paragraph clarifies that paragraph 3 does not impose such a restriction and that a Contracting State is not limited to providing only the information that it already has in its own files.

Paragraph 3

Paragraph 3 provides that the obligations undertaken in paragraphs 1 and 2 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 a Contracting State required 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.

Thus, a requesting State may be denied information from the other State if the information would be obtained pursuant to procedures or measures that are broader than those available in the requesting State. However, the statute of limitations of the Contracting State making the request for information should govern a request for information. Thus, the Contracting State of which the request is made should attempt to obtain the information even if its own statute of limitations has passed. In many cases, relevant information will still exist in the business records of the taxpayer or a third party, even though it is no longer required to be kept for domestic tax purposes.

While paragraph 3 states conditions under which a Contracting State is not obligated to comply with a request from the other Contracting State for information, the requested State is not precluded from providing such information, and may, at its discretion, do so subject to the limitations of its internal law.

Paragraph 7 of the Protocol provides that the powers of each Contracting State's competent authority to obtain information include powers to obtain information held by financial institutions, nominees, or persons acting in an agency or fiduciary capacity (not including information that would reveal confidential communications between a client and an attorney, solicitor, or other legal representative, where the client seeks legal advice), and information relating to the ownership of legal persons. Paragraph 7 of the Protocol acknowledges that each Contracting State's competent authority is able to exchange such information in accordance with Article 25. The provisions of paragraph 7 of the Protocol prevent a Contracting State from relying on paragraph 3 of the Convention to argue that its domestic bank secrecy laws (or similar legislation relating to disclosure of financial information by financial institutions or intermediaries) override its obligation to provide information under paragraph 1.

Paragraph 4

Paragraph 4 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).

The intention is to ensure that the information may be introduced as evidence 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 5

Paragraph 5 provides for assistance in collection of taxes to the extent necessary to ensure that treaty benefits are enjoyed only by persons entitled to those benefits under the terms of the Convention. Under paragraph 5, a Contracting State will endeavor to collect on behalf of the other State only those amounts necessary to ensure that any exemption or reduced rate of tax at source granted under the Convention by that other State is not enjoyed by persons not entitled to those benefits. For example, if the payer of a U.S.-source portfolio dividend receives a Form W-8BEN or other appropriate documentation from the payee, the withholding agent is permitted to withhold at the portfolio dividend rate of 15 percent. If, however, the addressee is merely acting as a nominee on behalf of a third-country resident, paragraph 5 would obligate the other Iceland to withhold and remit to the United States the additional tax that should have been collected by the U.S. withholding agent.

This paragraph also makes clear that the Contracting State asked to collect the tax is not obligated, in the process of providing collection assistance, 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.

Paragraph 6

Paragraph 6 provides that a Contracting State must notify the competent authority of the other Contracting State before sending representatives to enter the requested State to interview individuals and examine books and records with the consent of the persons subject to examination.

ARTICLE 26 (MEMBERS OF DIPLOMATIC MISSIONS AND CONSULAR POSTS)

This Article confirms 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. The agreements referred to include any bilateral agreements, such as consular conventions, that affect the taxation of diplomats and consular officials and any multilateral agreements dealing with these issues, such as the Vienna Convention on Diplomatic Relations and the Vienna Convention on Consular Relations. The U.S. generally adheres to the latter because its terms are consistent with customary international law.

The Article does not independently provide any benefits to diplomatic agents and consular officers. Article 18 (Government Service) does so, as do Code section 893 and a number of bilateral and multilateral agreements. In the event that there is a conflict between the Convention and international law or such other treaties, under which the diplomatic agent or consular official is entitled to greater benefits under the latter, the latter laws or agreements shall have precedence. Conversely, if the Convention confers a greater benefit than another agreement, the affected person could claim the benefit of the tax treaty.

Pursuant to subparagraph 5(b) of Article 1 (General Scope), the saving clause of paragraph 4 of Article 1 does not apply to override any benefits of this Article available to an individual who is neither a citizen of the United States nor has immigrant status in the United States.

ARTICLE 27 (ENTRY INTO FORCE)

This Article contains the rules for bringing the Convention into force and giving effect to its provisions.

Paragraph 1

Paragraph 1 provides that the Convention is subject to ratification in accordance with the applicable procedures of the United States and Iceland. Further, the Contracting States shall notify each other by written notification, through diplomatic channels, when their respective applicable procedures have been satisfied.

In the United States, the process leading to ratification and entry into force is as follows: Once a treaty has been signed by authorized representatives of the two Contracting States, the Department of State sends the treaty to the President who formally transmits it to the Senate for its advice and consent to ratification, which requires approval by two-thirds of the Senators present and voting. Prior to this vote, however, it generally has been the practice for the Senate Committee on Foreign Relations to hold hearings on the treaty and make a recommendation regarding its approval to the full Senate. Both Government and private sector witnesses may testify at these hearings. After the Senate gives its advice and consent to ratification of the treaty, an instrument of ratification is drafted for the President's signature. The President's signature completes the process in the United States.

Paragraph 2

Paragraph 2 provides that the Convention will enter into force on the date of the later of the notifications referred to in paragraph 1. The relevant date is the date on the second of these notification documents, and not the date on which the second notification is provided to the other Contracting State. The date on which a treaty enters into force is not necessarily the date on which its provisions take effect. Paragraph 2, therefore, also contains rules that determine when the provisions of the treaty will have effect.

Under subparagraph 2(a), the Convention will have effect with respect to taxes withheld at source (principally dividends, interest and royalties) for income derived on or after the first day of January in the first calendar year following the date on which the Convention enters into force. For all other taxes, subparagraph 2(b) specifies that the Convention will have effect for taxes chargeable for any tax year beginning on or after January 1 of the year following entry into force.

Paragraph 3

Paragraph 3 provides an exception to the general rule of paragraph 2. Under paragraph 3, if the prior income tax convention between the United States and Iceland would have afforded greater relief from tax than this Convention, that prior convention shall, at the election of any person that was entitled to benefits under the prior convention, continue to have effect in its

entirety for a twelve-month period from the date on which this Convention otherwise would have had effect with respect to such person.

Thus, a taxpayer may elect to extend the benefits of the prior convention for one year from the date on which the relevant provision of the new Convention would first take effect. During the period in which the election is in effect, the provisions of the prior convention will continue to apply only insofar as they applied before the entry into force of the Convention. If the grace period is elected, all of the provisions of the prior convention must be applied for that additional year. The taxpayer may not apply certain, more favorable provisions of the prior convention and, at the same time, apply other, more favorable provisions of this Convention. The taxpayer must choose one convention in its entirety or the other.

The prior convention shall terminate on the last date on which it has effect with respect to any tax in accordance with the provisions of Article 28.

Paragraph 4

Paragraph 4 provides that an individual who was entitled to benefits under Article 21 (Teachers) of the prior convention at the time of the entry into force of this Convention is "grandfathered," and will continue to be entitled to the benefits available under the prior convention until such time as that individual would cease to be entitled to benefits if the prior convention remained in force.

ARTICLE 28 (TERMINATION)

The Convention is to remain in effect indefinitely, unless terminated by one of the Contracting States in accordance with the provisions of Article 28. The Convention may be terminated by giving notice of termination in writing at least six months before the end of any calendar year. If notice of termination is given, the provisions of the Convention with respect to withholding at source will cease to have effect on income derived on or after the first day of January in the first calendar year following the year in which notice is given. For other taxes, the Convention will cease to have effect for taxes chargeable for any tax year beginning on or after the first day of January in the first calendar year following the year in which notice is given.

Article 28 relates only to unilateral termination of the Convention by a Contracting State. Nothing in that Article should be construed as preventing the Contracting States from concluding a new bilateral agreement, subject to ratification, that supersedes, amends or terminates provisions of the Convention without the notification period.

Customary international law observed by the United States and other countries, as reflected in the Vienna Convention on Treaties, allows termination by one Contracting State at any time in the event of a "material breach" of the agreement by the other Contracting State.

DEPARTMENT OF THE TREASURY
TECHNICAL EXPLANATION OF
\THE CONVENTION BETWEEN
THE UNITED STATES OF AMERICA AND
THE REPUBLIC OF BULGARIA
FOR THE AVOIDANCE OF DOUBLE TAXATION AND
THE PREVENTION OF FISCAL EVASION
WITH RESPECT TO TAXES ON INCOME,
SIGNED AT WASHINGTON ON FEBRUARY 23, 2007

This is a technical explanation of the Convention between the United States and Bulgaria for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed on February 23, 2007, and the Protocol between the United States and Bulgaria signed on the same date (the "Protocol"), as amended by the Protocol between the United States and Bulgaria signed on February 26, 2008 (collectively, the "Convention"). The Protocol is discussed below in connection with the relevant articles of the Convention.

Negotiations took into account the U.S. Treasury Department's current tax treaty policy, and the Treasury Department's Model Income Tax Convention, updated as of November 15, 2006. Negotiations also took into account the Model Tax Convention on Income and on Capital, published by the Organisation for Economic Cooperation and Development (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 during the negotiations 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 and her."

ARTICLE 1 (GENERAL SCOPE)

Paragraph 1

Paragraph 1 of Article 1 provides that the Convention applies only to residents of the United States or Bulgaria except where the terms of the Convention provide otherwise. Under Article 4 (Resident) a person is generally 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, citizenship, residence, or other similar criteria. However, if a person is considered a resident of both Contracting States, Article 4 provides rules for determining a State of residence (or no State of residence). This determination governs for all purposes of the Convention.

Certain provisions are applicable to persons who may not be residents of either Contracting State. For example, paragraph 1 of Article 23 (Non-Discrimination) applies to nationals of the Contracting States. Under Article 25 (Exchange of Information and Administrative Assistance), information may be exchanged with respect to residents of third states.

Paragraph 2

Paragraph 2 states the generally accepted relationship both between the Convention and domestic law and between the Convention and other agreements between the Contracting States. That is, no provision in the Convention may restrict any exclusion, exemption, deduction, credit or other benefit accorded by the tax laws of the Contracting States, or by any other agreement between the Contracting States. The relationship between the non-discrimination provisions of the Convention and other agreements is addressed not in paragraph 2 but in paragraph 3.

Under paragraph 2, for example, if a deduction would be allowed under the U.S. Internal Revenue Code (the "Code") in computing the U.S. taxable income of a resident of Bulgaria, the deduction also is allowed to that person in computing taxable income under the Convention. Paragraph 2 also means that the Convention may not increase the tax burden on a resident of a Contracting State beyond the burden determined under domestic law. Thus, a right to tax given by the Convention cannot be exercised unless that right also exists under internal law.

It follows that, under the principle of paragraph 2, a taxpayer's U.S. tax liability need not be determined under the Convention if the Code would produce a more favorable result. A taxpayer may not, however, choose among the provisions of the Code and the Convention in an inconsistent manner in order to minimize tax. A taxpayer may use the treaty to reduce its taxable income, but may not use both treaty and Code rules where doing so would thwart the intent of either set of rules. For example, assume that a resident of Bulgaria 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 taxable income under the Code but 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 in the United States, and both the profit and loss of the other two businesses are ignored. Under the Code, all three would be subject to tax, but the loss would offset 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. 308. If, however, 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.

Similarly, nothing in the Convention can be used to deny any benefit granted by any other agreement between the United States and Bulgaria. For example, if certain benefits are provided for military personnel or military contractors under a Status of Forces Agreement between the United States and Bulgaria, those benefits or protections will be available to residents of the Contracting States regardless of any provisions to the contrary (or silence) in the Convention.

Paragraph 3

Paragraph 3 specifically relates to non-discrimination obligations of the Contracting States under the General Agreement on Trade in Services (the "GATS"). 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 benefit now or hereafter accorded by any other agreement between the Contracting States.

Subparagraph 3(a) provides that, unless the competent authorities determine that a taxation measure is not within the scope of the Convention, the national treatment obligations of the GATS shall not apply with respect to that measure. Further, any question arising as to the

interpretation of the Convention, including in particular whether a measure is within the scope of the Convention shall be considered only by the competent authorities of the Contracting States, and the procedures under the Convention exclusively shall apply to the dispute. Thus, paragraph 3 of Article XXII (Consultation) of the GATS may not be used to bring a dispute before the World Trade Organization unless the competent authorities of both Contracting States have determined that the relevant taxation measure is not within the scope of Article 23 (Non-Discrimination) of the Convention.

The term "taxation measure" for these purposes is defined broadly in subparagraph 3(b). It would include, for example, a law, regulation, rule, procedure, decision, administrative action or guidance, or any other form of measure relating to taxation.

Paragraph 4

Paragraph 4 contains the traditional saving clause found in all U.S. treaties. The Contracting States reserve their rights, except as provided in paragraph 5, to tax their residents and citizens as provided in their internal laws, notwithstanding any provisions of the Convention to the contrary. For example, if a resident of Bulgaria performs professional services in the United States and the income from the services is not attributable to a permanent establishment in the United States, Article 7 (Business Profits) would by its terms prevent the United States from taxing the income. If, however, the resident of Bulgaria 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 (*i.e.*, without regard to Code section 894(a)). However, subparagraph 5(a) of Article 1 preserves the benefits of special foreign tax credit rules applicable to the U.S. taxation of certain U.S. income of its citizens resident in Bulgaria. See paragraph 4 of Article 22 (Relief from Double Taxation).

For purposes of the saving clause, "residence" is determined under Article 4 (Resident). Thus, an individual who is a resident of the United States under the Code (but not a U.S. citizen) but who is determined to be a resident of Bulgaria under the tie-breaker rules of Article 4 would be subject to U.S. tax only to the extent permitted by the Convention. The United States would not be permitted to apply its statutory rules to that person to the extent the rules are inconsistent with the treaty.

However, the person would be treated as a U.S. resident for U.S. tax purposes other than determining the individual's U.S. tax liability. For example, in determining under Code section 957 whether a foreign corporation is a controlled foreign corporation, shares in that corporation held by the individual would be considered to be held by a U.S. resident. As a result, other U.S. citizens or residents might be deemed to be United States shareholders of a controlled foreign corporation subject to current inclusion of Subpart F income recognized by the corporation. See Treas. Reg. section 301.7701(b)-7(a)(3).

Under paragraph 4, the United States also reserves its right to tax former citizens and former long-term residents for a period of ten years following the loss of such status with respect to income from sources within the United States (including income deemed under the domestic law of the United States to arise from such sources). Thus, paragraph 4 allows the United States to tax former U.S. citizens and former U.S. long-term residents in accordance with section 877 of the Code. Section 877 generally applies to a former citizen or long-term resident of the United States who relinquishes citizenship or terminates long-term residency before June 17, 2008 if either of the following criteria exceed established thresholds: (a) the average annual net income tax of such individual for the period of 5 taxable years ending before the date of the loss of status, or (b) the net worth of such individual as of the date of the loss of status. Paragraph 1 of the Protocol provides that the term "long-term resident" means any individual who is a lawful permanent resident of the United States in eight or more taxable years during the preceding 15

taxable years. In determining whether the eight-year threshold is met, one does not count any year in which the individual is treated as a resident of Bulgaria under the Convention (or as a resident of any country other than the United States under the provisions of any other U.S. tax treaty), and the individual does not waive the benefits of such treaty applicable to residents of the other country. This understanding is consistent with how this provision is generally interpreted in U.S. tax treaties..

Paragraph 5

Paragraph 5 sets forth certain exceptions to the saving clause. The referenced provisions are intended to provide benefits to citizens and residents even if such benefits do not exist under internal law. Paragraph 5 thus preserves these benefits for citizens and residents of the Contracting States.

Subparagraph (a) lists certain provisions of the Convention that are applicable to all citizens and residents of a Contracting State, despite the general saving clause rule of paragraph 4:

(1) Paragraph 2 of Article 9 (Associated Enterprises) grants the right to a correlative adjustment with respect to income tax due on profits reallocated under Article 9.

(2) Paragraphs 2 and 5 of Article 17 (Pensions, Social Security Payments, Annuities, Alimony, and Child Support) provide exemptions from source or residence State taxation for certain pension distributions and social security payments.

(3) Article 22 (Relief from Double Taxation) confirms to citizens and residents of one Contracting State the benefit of a credit for income taxes paid to the other or an exemption for income earned in the other State.

(4) Article 23 (Non-Discrimination) protects residents and nationals of one Contracting State against the adoption of certain discriminatory practices in the other Contracting State.

(5) Article 24 (Mutual Agreement Procedure) confers certain benefits on citizens and residents of the Contracting States in order to reach and implement solutions to disputes between the two Contracting States. For example, the competent authorities are permitted to use a definition of a term that differs from an internal law definition. The statute of limitations may be waived for refunds, so that the benefits of an agreement may be implemented.

Subparagraph 5(b) provides a different set of exceptions to the saving clause. The benefits referred to are all intended to be granted to temporary residents of a Contracting State (for example, in the case of the United States, holders of non-immigrant visas), but not to citizens or to persons who have acquired permanent residence in that State. If beneficiaries of these provisions travel from one of the Contracting States to the other, and remain in the other long enough to become residents under its internal law, but do not acquire permanent residence status (i.e., in the U.S. context, they do not become "green card" holders) and are not citizens of that State, the host State will continue to grant these benefits even if they conflict with the statutory rules. The benefits preserved by this paragraph are: (1) the host country exemptions for government service salaries and pensions under Article 18 (Government Service), certain income of visiting students, trainees, teachers, and researchers under Article 19 (Students, Trainees, Teachers and Researchers), and the income of diplomatic agents and consular officers under Article 26 (Members of Diplomatic Missions and Consular Posts).

Paragraph 6

Paragraph 6 addresses special issues presented by fiscally transparent entities such as partnerships and certain estates and trusts. Because different countries frequently take different views as to when an entity is fiscally transparent, the risk of both double taxation and double non-taxation are relatively high. The intention of paragraph 6 is to eliminate a number of technical problems that arguably would have prevented investors using such entities from claiming treaty benefits, even though such investors would be subject to tax on the income derived through such entities. The provision also prevents the use of such entities to claim treaty benefits in circumstances where the person investing through such an entity is not subject to tax on the income in its State of residence. The provision, and the corresponding requirements of the substantive rules of Articles 6 through 20, should be read with those two goals in mind.

In general, paragraph 6 relates to entities that are not subject to tax at the entity level, as distinct from entities that are subject to tax, but with respect to which tax may be relieved under an integrated system. This paragraph applies to any resident of a Contracting State who is entitled to income derived through an entity that is treated as fiscally transparent under the laws of either Contracting State. Entities falling under this description in the United States include partnerships, common investment trusts under section 584 and grantor trusts. This paragraph also applies to U.S. limited liability companies ("LLCs") that are treated as partnerships or as disregarded entities for U.S. tax purposes.

Under paragraph 6, an item of income derived by such a fiscally transparent entity will be considered to be derived by a resident of a Contracting State if a resident is treated under the taxation laws of that State as deriving the item of income. For example, if a company that is a resident of Bulgaria pays interest to an entity that is treated as fiscally transparent for U.S. tax purposes, the interest will be considered derived by a resident of the United States only to the extent that the taxation laws of the United States treats one or more U.S. residents (whose status as U.S. residents is determined, for this purpose, under U.S. tax law) as deriving the interest for U.S. tax purposes. In the case of a partnership, the persons who are, under U.S. tax laws, treated as partners of the entity would normally be the persons whom the U.S. tax laws would treat as deriving the interest income through the partnership. Also, it follows that persons whom the United States treats as partners but who are not U.S. residents for U.S. tax purposes may not claim a benefit for the interest paid to the entity under the Convention, because they are not residents of the United States for purposes of claiming this treaty benefit. (If, however, the country in which they are treated as resident for tax purposes, as determined under the laws of that country, has an income tax convention with Bulgaria, they may be entitled to claim a benefit under that convention.) In contrast, if, for example, an entity is organized under U.S. laws and is classified as a corporation for U.S. tax purposes, interest paid by a company that is a resident of Bulgaria to the U.S. entity will be considered derived by a resident of the United States since the U.S. corporation is treated under U.S. taxation laws as a resident of the United States and as deriving the income.

The same result obtains even if the entity were viewed differently under the tax laws of Bulgaria (*e.g.*, as not fiscally transparent in the first example above where the entity is treated as a partnership for U.S. tax purposes). Similarly, the characterization of the entity in a third country is also irrelevant, even if the entity is organized in that third country. The results follow regardless of whether the entity is disregarded as a separate entity under the laws of one jurisdiction but not the other, such as a single owner entity that is viewed as a branch for U.S. tax purposes and as a corporation for tax purposes under the laws of Bulgaria. These results also obtain regardless of where the entity is organized (*i.e.*, in the United States, in Bulgaria or, as noted above, in a third country).

For example, income from U.S. sources received by an entity organized under the laws of the United States, which is treated for tax purposes under the laws of Bulgaria as a corporation and is owned by a shareholder who is a resident of Bulgaria for its tax purposes, is not considered derived by the shareholder of that corporation even if, under the tax laws of the United States, the entity is treated as fiscally transparent. Rather, for purposes of the treaty, the income is treated as derived by the U.S. entity.

These principles also apply to trusts to the extent that they are fiscally transparent in either Contracting State. For example, if X, a resident of Bulgaria, creates a revocable trust in the United States and names persons resident in a third country as the beneficiaries of the trust, the trust's income would be regarded as being derived by a resident of Bulgaria only to the extent that the laws of Bulgaria treat X as deriving the income for its tax purposes, perhaps through application of rules similar to the U.S. "grantor trust" rules.

Paragraph 6 is not an exception to the saving clause of paragraph 4. Accordingly, paragraph 6 does not prevent a Contracting State from taxing an entity that is treated as a resident of that State under its tax law. For example, if a U.S. LLC with members who are residents of Bulgaria elects to be taxed as a corporation for U.S. tax purposes, the United States will tax that LLC on its worldwide income on a net basis, without regard to whether Bulgaria views the LLC as fiscally transparent.

ARTICLE 2 (TAXES COVERED)

This Article specifies the U.S. taxes and the taxes of Bulgaria to which the Convention applies. With two exceptions, the taxes specified in Article 2 are the covered taxes for all purposes of the Convention. A broader coverage applies, however, for purposes of Articles 23 (Non-Discrimination) and 25 (Exchange of Information and Administrative Assistance). Article 23 (Non-Discrimination) applies with respect to all taxes, including those imposed by state and local governments. Article 25 (Exchange of Information and Administrative Assistance) applies with respect to all taxes imposed at the national level.

Paragraph 1

Paragraph 1 identifies the category of taxes to which the Convention applies. Paragraph 1 is based on the U.S. and OECD Models and defines the scope of application of the Convention. The Convention applies to taxes on income, including gains, imposed on behalf of a Contracting State, irrespective of the manner in which they are levied. Except with respect to Article 23 (Non-Discrimination), state and local taxes are not covered by the Convention.

Paragraph 2

Paragraph 2 also is based on the U.S. and OECD Models and provides a definition of taxes on income and on capital gains. The Convention covers taxes on total income or any part of income and includes tax on gains derived from the alienation of property. The Convention does not apply, however, to social security charges, or any other charges where there is a direct connection between the levy and individual benefits. Nor does it apply to property taxes, except with respect to Article 23 (Non-Discrimination).

Paragraph 3

Paragraph 3 lists the taxes in force at the time of signature of the Convention to which the Convention applies.

The existing covered taxes of Bulgaria are identified in subparagraph 3(a), as the personal income tax and the corporate income tax. Paragraph 2 of the Protocol clarifies that these taxes include the patent tax, which is a tax imposed on certain small business operations in lieu of a net basis income tax.

Subparagraph 3(b) provides that the existing U.S. taxes subject to the rules of the Convention are the Federal income taxes imposed by the Code, together with the excise taxes imposed with respect to the investment income of foreign private foundations (Code section 4940). Social security and unemployment taxes (Code sections 1401, 3101, 3111 and 3301) are excluded from coverage.

Paragraph 4

Under paragraph 4, the Convention will apply to any taxes that are identical, or substantially similar, to those enumerated in paragraph 3, and which are imposed in addition to, or in place of, the existing taxes after February 23, 2007, the date of signature of the Convention. The paragraph also provides that the competent authorities of the Contracting States will notify each other of any changes that have been made in their laws, whether tax laws or non-tax laws, that significantly affect their obligations under the Convention. Non-tax laws that may affect a Contracting State's obligations under the Convention may include, for example, laws affecting bank secrecy.

ARTICLE 3 (GENERAL DEFINITIONS)

Article 3 provides general definitions and rules of interpretation applicable throughout 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). These definitions are used consistently throughout the Convention. Other terms, such as "dividends," "interest" and "royalties" are defined in specific articles for purposes only of those articles.

Paragraph 1

Paragraph 1 defines a number of basic terms used in the Convention. The introduction to paragraph 1 makes clear that these definitions apply for all purposes of the Convention, unless the context requires otherwise. This latter condition allows flexibility in the interpretation of the Convention in order to avoid results not intended by the Convention's negotiators.

The geographical scope of the Convention with respect to Bulgaria is set out in subparagraph 1(a). The term "Bulgaria" encompasses the Republic of Bulgaria, including the territory and the territorial sea over which it exercises its State sovereignty, as well as the continental shelf and the exclusive economic zone over which it exercises sovereign rights and jurisdiction in conformity with international law.

The geographical scope of the Convention with respect to the United States is set out in subparagraph 1(b). It encompasses the United States of America, including the states, the District of Columbia and the territorial sea of the United States. The term does not include Puerto Rico, the Virgin Islands, Guam or any other U.S. possession or territory. For certain purposes, the term "United States" includes the sea bed and subsoil of undersea areas adjacent to the territorial sea of the United States. This extension applies to the extent that the United States exercises sovereignty in accordance with international law for the purpose of natural resource exploration and exploitation of such areas. This extension of the definition applies, however, only if the person, property or activity to which the Convention is being applied is connected with such natural resource exploration or exploitation. Thus, it would not include any activity

involving the sea floor of an area over which the United States exercised sovereignty for natural resource purposes if that activity was unrelated to the exploration and exploitation of natural resources. This result is consistent with the result that would be obtained under Code section 638, which treats the continental shelf as part of the United States for purposes of natural resource exploration and exploitation.

Subparagraph 1(c) provides that the terms "a Contracting State" and "the other Contracting State" shall mean Bulgaria or the United States, as the context requires.

Subparagraph 1(d) defines the term "person" to include an individual, a company and any other body of persons. Paragraph 3 of the Protocol clarifies that the term "any other body of persons" includes partnerships, trusts, and estates. The definition is significant for a variety of reasons. For example, under Article 4, only a "person" can be a "resident" and therefore eligible for most benefits under the Convention. Also, all "persons" are eligible to claim relief under Article 24 (Mutual Agreement Procedure).

The term "company" is defined in subparagraph 1(e) as a body corporate or an entity treated as a body corporate for tax purposes in the state where it is organized. The definition refers to the law of the state in which an entity is organized in order to ensure that an entity that is treated as fiscally transparent in its country of residence will not get inappropriate benefits, such as the reduced withholding rate provided by subparagraph 2(b) of Article 10 (Dividends). It also ensures that the Limitation on Benefits provisions of Article 21 will be applied at the appropriate level.

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. An enterprise of a Contracting State need not be carried on in that State. It may be carried on in the other Contracting State or a third state (e.g., a U.S. corporation doing all of its business in Bulgaria would still be a U.S. enterprise).

These terms also encompass an enterprise conducted through an entity (such as a partnership) that is treated as fiscally transparent in the Contracting State where the entity's owner is resident. In accordance with Article 4 (Resident), entities that are fiscally transparent in the Contracting State in which their owners are resident are not considered to be residents of that Contracting State (although income derived by such entities may be taxed as the income of a resident, if taxed in the hands of resident partners or other owners). An enterprise conducted by such an entity will be treated as carried on by a resident of a Contracting State to the extent its partners or other owners are residents. This approach is consistent with the Code, which under section 875 attributes a trade or business conducted by a partnership to its partners and a trade or business conducted by an estate or trust to its beneficiaries.

Subparagraph (g) defines the term "enterprise" as any activity or set of activities that constitutes the carrying on of a business. The term "business" is not defined, but subparagraph (h) provides that it includes the performance of professional services and other activities of an independent character. Both subparagraphs are identical to definitions recently added to the OECD Model in connection with the deletion of Article 14 (Independent Personal Services) from the OECD Model. The inclusion of the two definitions is intended to clarify that income from the performance of professional services or other activities of an independent character is dealt with under Article 7 (Business Profits) and not Article 20 (Other Income). Subparagraph (i) further clarifies, at the request of Bulgaria, that "business profits" also include income from the performance of professional services and other activities of an independent character.

Subparagraph 1(j) 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 carriage of goods or passengers solely between New York and Chicago would not be treated as international traffic, whether carried by a U.S. or a foreign carrier. The substantive taxing rules of the Convention relating to the taxation of income from transport, principally Article 8 (International Traffic), therefore, would not apply to income from such carriage. Thus, if the carrier engaged in internal U.S. traffic were a resident of Bulgaria (assuming that were possible under U.S. law), the United States would not be required to exempt the income from that transport 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 of the foreign carrier, and then only on a net basis. The gross basis U.S. tax imposed by section 887 would never apply under the circumstances described. If, however, goods or passengers are carried by a carrier resident in Bulgaria from a non-U.S. port to, for example, New York, and some of the goods or passengers continue on to Chicago, the entire transport would be international traffic. This would be true if the international carrier transferred the goods at the U.S. port of entry from a ship to a land vehicle, from a ship to a lighter, or even if the overland portion of the trip in the United States was handled by an independent carrier under contract with the original international carrier, so long as both parts of the trip were reflected in original bills of lading. For this reason, the Convention, following the U.S. Model refers, in the definition of "international traffic," to "such transport" being solely between places in the other Contracting State, while the OECD Model refers to the ship or aircraft being operated solely between such places. The formulation in the Convention is intended to make clear that, as in the above example, even if the goods are carried on a different aircraft for the internal portion of the international voyage than is used for the overseas portion of the trip, the definition applies to that internal portion as well as the external portion.

Finally, a "cruise to nowhere," i.e., a cruise beginning and ending in a port in the same Contracting State with no stops in a foreign port, would not constitute international traffic.

Subparagraph 1(k) designates the "competent authorities" for Bulgaria and the United States. The Bulgarian competent authority is the Minister of Finance or an authorized representative. The U.S. competent authority is the Secretary of the Treasury or his delegate. The Secretary of the Treasury has delegated the competent authority function to the Commissioner of Internal Revenue, who in turn has delegated the authority to the Deputy Commissioner (International) LMSB. With respect to interpretative issues, the Deputy Commissioner (International) LMSB acts with the concurrence of the Associate Chief Counsel (International) of the Internal Revenue Service.

The term "national," as it relates to the United States and to Bulgaria, is defined in subparagraph 1(l). This term is relevant for purposes of Articles 18 (Government Service) and 23 (Non-Discrimination). A national of one of the Contracting States is (1) an individual who is a citizen of that State, and (2) any legal person, partnership or association deriving its status, as such, from the law in force in the State where it is established.

Subparagraph 1(m) defines the term "pension fund" to include any person established in a Contracting State that is generally exempt from income taxation in that State and that is operated principally to administer or provide pension or retirement benefits or to earn income for the benefit of one or more such arrangements. In the case of the United States, the term "pension fund" includes the following: a trust providing pension or retirement benefits under a Code section 401(a) qualified pension plan, profit sharing or stock bonus plan, a trust providing pension or retirement benefits under a Code section 403(b) plan, a trust that is an individual retirement account under Code section 408, a Roth individual retirement account under Code

section 408A, or a simple retirement account under Code section 408(p), a trust providing pension or retirement benefits under a simplified employee pension plan under Code section 408(k), a trust described in section 457(g) providing pension or retirement benefits under a Code section 457(b) plan, and the Thrift Savings Fund (section 7701(j)). Section 401(k) plans and group trusts described in Rev. Rul. 81-100, 1981-1 C.B. 326, and meeting the conditions of Rev. Rul. 2004-67, 2204-2 C.B. 28, qualify as pension funds because they are covered by Code section 401(a).

Paragraph 2

Terms that are not defined in the Convention are dealt with in paragraph 2.

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 otherwise, or the competent authorities have agreed on a different meaning pursuant to Article 24 (Mutual Agreement Procedure). If the term is defined under both the tax and non-tax laws of a Contracting State, the definition in the tax law will take precedence over the definition in the non-tax laws. Finally, there also may be cases where the tax laws of a State contain multiple definitions of the same term. In such a case, the definition used for purposes of the particular provision at issue, if any, should be used.

If 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, as indicated in paragraph 3(f) of Article 24 (Mutual Agreement Procedure), may establish a common meaning in order to prevent double taxation or to 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.

The reference in paragraph 2 to the internal law of a Contracting State means the law in effect at the time the Convention is being applied, not the law as in effect at the time the Convention was signed. The use of "ambulatory" definitions, however, may lead to results that are at variance with the intentions of the negotiators and of the Contracting States when the Convention was negotiated and ratified. The reference in both paragraphs 1 and 2 to the "context otherwise requir[ing]" a definition different from the Convention definition, in paragraph 1, or from the internal law definition of the Contracting State whose tax is being imposed, under paragraph 2, refers to a circumstance where the result intended by the Contracting States is different from the result that would obtain under either the paragraph 1 definition or the statutory definition. Thus, flexibility in defining terms is necessary and permitted.

ARTICLE 4 (RESIDENT)

This Article sets forth rules for determining whether a person is a resident of a Contracting State for purposes of the Convention. As a general matter only residents of the Contracting States may claim the benefits of the Convention. The treaty definition of residence is to be used only for purposes of the Convention. The fact that a person is determined to be a resident of a Contracting State under Article 4 does not necessarily entitle that person to the benefits of the Convention. In addition to being a resident, a person also must qualify for benefits under Article 21 (Limitation on Benefits) in order to receive benefits conferred on residents of a Contracting State.

The determination of residence for treaty purposes looks first to a person's liability to tax as a resident under the respective taxation laws of the Contracting States. As a general matter, 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. If, however, a person is resident in both Contracting States under their respective taxation laws, the Article proceeds, where possible, to use tie-breaker rules to assign a single State of residence to such a person for purposes of the Convention.

Paragraph 1

The term "resident of a Contracting State" is defined in paragraph 1. In general, this definition incorporates the definitions of residence in U.S. law and that of Bulgaria by referring to a resident as a person who, under the laws of a Contracting State, is subject to tax there by reason of his domicile, residence, citizenship, place of management, place of incorporation or any other similar criterion. Thus, residents of the United States include aliens who are considered U.S. residents under Code section 7701(b). Paragraph 1 also specifically includes the two Contracting States, and political subdivisions and local authorities of the two States, as residents for purposes of the Convention.

Certain entities that are nominally subject to tax but that in practice are rarely required to pay tax also would generally be treated as residents and therefore accorded treaty benefits. For example, a U.S. Regulated Investment Company (RIC) and a U.S. Real Estate Investment Trust (REIT) are residents of the United States for purposes of the treaty. Although the income earned by these entities normally is not subject to U.S. tax in the hands of the entity, they are taxable to the extent that they do not currently distribute their profits, and therefore may be regarded as "liable to tax." They also must satisfy a number of requirements under the Code in order to be entitled to special tax treatment.

Under paragraph 1 of the Convention and paragraph 4 of the Protocol, a person who is liable to tax in a Contracting State only in respect of income from sources within that State or of profits attributable to a permanent establishment in that State will not be treated as a resident of that Contracting State for purposes of the Convention. Thus, a consular official of Bulgaria who is posted 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. source income (see Code section 7701(b)(5)(B)), would not be considered a resident of the United States for purposes of the Convention. Similarly, an enterprise of Bulgaria with a permanent establishment in the United States is not, by virtue of that permanent establishment, a resident of the United States. The enterprise generally is subject to U.S. tax only with respect to its income that is attributable to the U.S. permanent establishment, not with respect to its worldwide income, as it would be if it were a U.S. resident.

Paragraph 4 of the Protocol also clarifies that if a company is a resident of one of the Contracting States under the domestic law of that State, but is treated as a resident of a third state under a treaty between that State and the third state, then it will not be treated as a resident of the Contracting State for purposes of the Convention. For example, if a company that is organized in Bulgaria is managed and controlled in the United Kingdom, both countries would treat the company as being a resident under its domestic laws. However, if a treaty between Bulgaria and the United Kingdom assigned residence in such a case to the country in which the company's place of effective management is located, and the place of effective management is the United Kingdom, the company would not qualify for benefits under the U.S.-Bulgaria treaty because it is not subject to tax in Bulgaria as a resident of Bulgaria. This rule is consistent with the holding of Rev. Rul. 2004-76, 2004-2 C.B. 111.

Paragraph 2

Paragraph 2 provides that certain tax-exempt entities such as pension funds and charitable organizations will be regarded as residents of a Contracting State regardless of whether they are generally liable to income tax in the State where they are established. The paragraph applies to legal persons organized under the laws of a Contracting State and established and maintained in that State to provide pensions or other similar benefits pursuant to a plan, or exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes. Thus, a section 501(c) organization organized in the United States (such as a U.S. charity) that is generally exempt from tax under U.S. law is a resident of the United States for all purposes of the Convention.

Paragraph 3

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 are provided in paragraph 3 to determine a single State of residence for that individual. These tests are to be applied in the order in which they are stated. The first test is based on 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 a habitual abode. If he has a habitual abode in both States or in neither of them, he will be treated as a resident of the Contracting State of which he is a national. 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

Dual residents other than individuals (such as companies, trusts, or estates) are addressed by paragraph 4. If such a person is, under the rules of paragraph 1 or 2, resident in both Contracting States, the competent authorities shall seek to determine a single State of residence for that person for purposes of the Convention. If the competent authorities do not reach an agreement on a single State of residence, that dual resident may not claim any benefit accorded to residents of a Contracting State by the Convention. The dual resident may, however, claim any benefits that are not limited to residents, such as those provided by paragraph 1 of Article 23 (Non-Discrimination). Thus, for example, a State cannot discriminate against a dual resident company.

Dual residents also may be treated as a resident of a Contracting State for purposes other than that of obtaining benefits under the Convention. For example, if a dual resident company pays a dividend to a resident of Bulgaria, the U.S. paying agent would withhold on that dividend at the appropriate treaty rate because reduced withholding is a benefit enjoyed by the resident of Bulgaria, not by the dual resident company. The dual resident company that paid the dividend would, for this purpose, be treated as a resident of the United States under the Convention. In addition, information relating to dual residents can be exchanged under the Convention because, by its terms, Article 26 (Exchange of Information and Administrative Assistance) is not limited to residents of the Contracting States.

ARTICLE 5 (PERMANENT ESTABLISHMENT)

This Article defines the term "permanent establishment," a term that is significant for 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. 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 that the recipient has in the source State. The concept is also relevant in determining which Contracting State may tax certain gains under Article 13 (Capital Gains) and certain "other income" under Article 20 (Other Income).

Paragraph 1

The basic definition of the term "permanent establishment" is contained in paragraph 1. 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. As indicated in the OECD Commentary to Article 5 (see paragraphs 4 through 8), a general principle to be observed in determining whether a permanent establishment exists is that the place of business must be "fixed" in the sense that a particular building or physical location is used by the enterprise for the conduct of its business, and that it must be foreseeable that the enterprise's use of this building or other physical location will be more than temporary.

Paragraph 2

Paragraph 2 lists a number of types of fixed places of business that constitute a permanent establishment. This list is illustrative and non-exclusive. 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

This paragraph provides rules to determine whether a building site or a construction, assembly or installation project, or an installation or drilling rig or ship used for the exploration of natural resources constitutes a permanent establishment for the contractor, driller, etc. Such a site or activity does not create a permanent establishment unless the site, project, etc. lasts, or the exploration activity continues, for more than six months. It is only necessary to refer to "exploration" and not "exploitation" in this context because exploitation activities are defined to constitute a permanent establishment under subparagraph (f) of paragraph 2. Thus, a drilling rig does not constitute a permanent establishment if a well is drilled in only three months, but if production begins in the following month the well becomes a permanent establishment as of that date.

The six-month test applies separately to each site or project. The six-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 by a contractor that are interdependent both commercially and geographically are to be treated as a single project for purposes of applying the six-month threshold test. For example, the construction of a housing development would be considered as a single project even if each house were constructed for a different purchaser.

In applying this paragraph, time spent by a sub-contractor on a building site is counted as time spent by the general contractor at the site for purposes of determining whether the general contractor has a permanent establishment. However, for the sub-contractor itself to be treated as having a permanent establishment, the sub-contractor's activities at the site must last for more than six months. If a sub-contractor is on a site intermittently, then, for purposes of applying the six-month rule, time is measured from the first day the sub-contractor is on the site until the last day (*i.e.*, intervening days that the sub-contractor is not on the site are counted).

These interpretations of the Article are based on the Commentary to paragraph 3 of Article 5 of the OECD Model, which contains language that is substantially the same as that in the Convention. These interpretations are consistent with the generally accepted international interpretation of the relevant language in paragraph 3 of Article 5 of the Convention.

If the six-month threshold is exceeded, the site or project constitutes a permanent establishment from the first day of activity.

Paragraph 4

This paragraph contains exceptions to the general rule of paragraph 1, listing a number of activities that may be carried on through a fixed place of business but which nevertheless do not create a permanent establishment. The use of facilities solely to store, display or deliver merchandise belonging to an enterprise does 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 does not give rise to a permanent establishment of the first-mentioned enterprise. The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or for collecting information, for the enterprise, or for other activities that have a preparatory or auxiliary character for the enterprise, such as advertising, or the supply of information, do not constitute a permanent establishment of the enterprise. Moreover, subparagraph 4(f) provides that a combination of the activities described in the other subparagraphs of paragraph 4 will not give rise to a permanent establishment if the combination results in an overall activity that is of a preparatory or auxiliary character.

Paragraph 5

Paragraphs 5 and 6 specify when activities carried on by an agent or other person acting on behalf of an enterprise create a permanent establishment of that enterprise. For example, under subparagraph 5(a), a person is deemed to create a permanent establishment of the enterprise if that person 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 which would not constitute a permanent establishment if carried on by the enterprise through a fixed place of business, the person does not create a permanent establishment of the enterprise.

The Convention adopts the OECD Model language "in the name of that enterprise" rather than the US Model language "binding on the enterprise." This difference in language is not intended to be a substantive difference. As indicated in paragraph 32 to the OECD Commentaries on Article 5, paragraph 5 of the Article is intended to encompass persons who have "sufficient authority to bind the enterprise's participation in the business activity in the State concerned."

The contracts referred to in paragraph 5 are those relating to the essential business operations of the enterprise, rather than ancillary activities. For example, if the person has no authority to conclude contracts in the name of the enterprise with its customers for, say, the sale of the goods produced by the enterprise, but it can enter into service contracts in the name of the enterprise for the enterprise's business equipment, this contracting authority would not fall within the scope of the paragraph, even if exercised regularly.

Under subparagraph 5(b), a person is also deemed to create a permanent establishment of the enterprise if that person has no authority to conclude contracts, but habitually maintains in that State a stock of goods or merchandise belonging to the enterprise from which the person regularly fills orders or makes deliveries on behalf of the enterprise, and additional activities

conducted in that State on behalf of the enterprise have contributed to the conclusion of the sale of such goods or merchandise.

Paragraph 6

Under paragraph 6, an enterprise is not deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through an independent agent, including a broker or general commission agent, if the agent is acting in the ordinary course of his business as an independent agent. Thus, there are two conditions that must be satisfied: the agent must be both legally and economically independent of the enterprise, and the agent must be acting in the ordinary course of its business in carrying out activities on behalf of the enterprise.

Whether the agent and the enterprise are independent is a factual determination. Among the questions to be considered is the extent to which the agent operates on the basis of instructions from the enterprise. An agent that is subject to detailed instructions regarding the conduct of its operations or comprehensive control by the enterprise is not legally independent.

In determining whether the agent is economically independent, a relevant factor is the extent to which the agent bears business risk. Business risk refers primarily to risk of loss. An independent agent typically bears risk of loss from its own activities. In the absence of other factors that would establish dependence, an agent that shares business risk with the enterprise, or has its own business risk, is economically independent because its business activities are not integrated with those of the principal. Conversely, an agent that bears little or no risk from the activities it performs is not economically independent and therefore is not described in paragraph 6.

Another relevant factor in determining whether an agent is economically independent is whether the agent acts exclusively or nearly exclusively for the principal. Such a relationship may indicate that the principal has economic control over the agent. A number of principals acting in concert also may have economic control over an agent. The limited scope of the agent's activities and the agent's dependence on a single source of income may indicate that the agent lacks economic independence. It should be borne in mind, however, that exclusivity is not in itself a conclusive test; an agent may be economically independent notwithstanding an exclusive relationship with the principal if it has the capacity to diversify and acquire other clients without substantial modifications to its current business and without substantial harm to its business profits. Thus, exclusivity should be viewed merely as a pointer to further investigation of the relationship between the principal and the agent. Each case must be addressed on the basis of its own facts and circumstances.

Paragraph 7

This paragraph clarifies that a company that is a resident of a Contracting State is not 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 is 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.

Paragraph 8

Paragraph 8 provides a special rule (subject to the provisions of paragraph 4) for an enterprise of a Contracting State that provides services in the other Contracting State, but that does not have a permanent establishment by virtue of the preceding paragraphs of the Article. If (and only if) such an enterprise meets either of two tests as provided in subparagraphs 8(a) and 8(b), the enterprise will be deemed to provide those services through a permanent establishment in the other State.

The first test as provided in subparagraph 8(a) has two parts. First, the services must be performed in the other State by an individual who is present in that other State for a period or periods aggregating 183 days or more in any twelve-month period. Second, during that period or periods, more than 50 percent of the gross active business revenues of the enterprise (including revenue from active business activities unrelated to the provision of services) must consist of income derived from the services performed in that State by that individual. If the enterprise meets both of these tests, the enterprise will be deemed to provide the services through a permanent establishment. This test in subparagraph 8(a) is employed to determine whether an enterprise is deemed to have a permanent establishment by virtue of the presence of a single individual (i.e. a natural person).

For the purposes of subparagraph 8(a), the term "gross active business revenues" shall mean the gross revenues attributable to active business activities that the enterprise has charged or should charge for its active business activities, regardless of when the actual billing will occur or of domestic law rules concerning when such revenues should be taken into account for tax purposes. Such active business activities are not restricted to the activities related to the provision of services. However, the term does not include income from passive investment activities.

The second test as provided in subparagraph 8(b) provides that an enterprise will have a permanent establishment if the services are provided in the other State for an aggregate of 183 days or more in any twelve-month period with respect to the same or connected projects for customers who either are residents of the other State or maintain a permanent establishment in the other State with respect to which the services are provided. The various conditions that have to be satisfied in order for subparagraph 8(b) to have application are described in detail below.

In addition to meeting the 183-day threshold, the services must be provided for customers who either are residents of the other State or maintain a permanent establishment in that State. The intent of this requirement is to reinforce the concept that unless there is a customer in the other State, such enterprise will not be deemed as participating sufficiently in the economic life of that other State to warrant being deemed to have a permanent establishment.

Paragraph 8 applies only to the provision of services, and only to services provided by an enterprise to third parties. Thus, the provision does not have the effect of deeming an enterprise to have a permanent establishment merely because services are provided to that enterprise.

Further, paragraph 8 only applies to services that are performed or provided by an enterprise of a Contracting State within the other Contracting State. It is therefore not sufficient that the relevant services be merely furnished to a resident of the other Contracting State. Where, for example, an enterprise provides customer support or other services by telephone or computer to customers located in the other State, those would not be covered by paragraph 8 because they are not performed or provided by that enterprise within the other State. Another example would be that of an architect who is hired to design blueprints for the construction of a building in the other State. As part of completing the project, the architect must make site visits to that other State, and his days of presence there would be counted for purposes of determining

whether the 183-day threshold is satisfied. However, the days that the architect spends working on the blueprint in his home office shall not count for purposes of the 183-day threshold, because the architect is not performing or providing those services within the other State.

For purposes of determining whether the time threshold has been met, subparagraph 8(b) permits the aggregation of services that are provided with respect to connected projects. For purposes of this test, projects shall be considered to be connected if they constitute a coherent whole, commercially and geographically. The determination of whether projects are connected should be determined from the point of view of the enterprise (not that of the customer), and will depend on the facts and circumstances of each case. In determining the existence of commercial coherence, factors that would be relevant include: 1) whether the projects would, in the absence of tax planning considerations, have been concluded pursuant to a single contract; 2) whether the nature of the work involved under different projects is the same; and 3) whether the same individuals are providing the services under the different projects. Whether the work provided is covered by one or multiple contracts may be relevant, but is not determinative, in finding that projects are commercially coherent.

The aggregation rule addresses, for example, potentially abusive situations in which work has been artificially divided into separate components in order to avoid meeting the 183-day threshold. Assume for example, that a technology consultant has been hired to install a new computer system for a company in the other country. The work will take ten months to complete. However, the consultant purports to divide the work into two five-month projects with the intention of circumventing the rule in paragraph 8. In such case, even if the two projects were considered separate, they will be considered to be commercially coherent. Accordingly, subject to the additional requirement of geographic coherence, the two projects could be considered to be connected, and could therefore be aggregated for purposes of subparagraph 8(b). In contrast, assume that the technology consultant is contracted to install a particular computer system for a company, and is also hired by that same company, pursuant to a separate contract, to train its employees on the use of another computer software that is unrelated to the first system. In this second case, even though the contracts are both concluded between the same two parties, there is no commercial coherence to the two projects, and the time spent fulfilling the two contracts may not be aggregated for purposes of subparagraph 8(b). Another example of projects that do not have commercial coherence would be the case of a law firm which, as one project provides tax advice to a customer from one portion of its staff, and as another project provides trade advice from another portion of its staff, both to the same customer.

Additionally, projects, in order to be considered connected, must also constitute a geographic whole. An example of projects that lack geographic coherence would be a case in which a consultant is hired to execute separate auditing projects at different branches of a bank located in different cities pursuant to a single contract. In such an example, while the consultant's projects are commercially coherent, they are not geographically coherent and accordingly the services provided in the various branches shall not be aggregated for purposes of applying subparagraph 8(b). The services provided in each branch should be considered separately for purposes of subparagraph 8(b).

The method of counting days for purposes of subparagraph 8(a) differs slightly from the method for subparagraph 8(b). Subparagraph 8(a) refers to days in which an individual is present in the other country. Accordingly, physical presence during a day is sufficient. In contrast, subparagraph 8(b) refers to days during which services are provided by the enterprise in the other country. Accordingly, non-working days such as weekends or holidays would not count for purposes of subparagraph 8(b), as long as no services are actually being provided while in the other country on those days. For the purposes of both subparagraphs, even if the enterprise sends many individuals simultaneously to the other country to provide services, their collective presence during one calendar day will count for only one day of the enterprise's

presence in the other country. For instance, if an enterprise sends 20 employees to the other country to provide services to a client in the other country for 10 days, the enterprise will be considered present in the other country only for 10 days, not 200 days (20 employees x 10 days).

By deeming the enterprise to provide services through a permanent establishment in the other Contracting State, paragraph 8 allows the application of Article 7 (Business Profits), and accordingly, the taxation of the services shall be on a net-basis. Such taxation is also limited to the profits attributable to the activities carried on in performing the relevant services. It will be important to ensure that only the profits properly attributable to the functions performed and risks assumed by provision of the services will be attributed to the deemed permanent establishment.

Paragraph 8 applies subject to the provisions of paragraph 4. In no case will paragraph 8 apply to deem services to be provided through a permanent establishment if the services are limited to those mentioned in paragraph 4 which, if performed through a fixed place of business, would not make the fixed place of business a permanent establishment under the provisions of that paragraph. Further, days spent on preparatory or auxiliary activities shall not be taken into account for purposes of applying subparagraph 8(b).

ARTICLE 6 (INCOME FROM IMMOVABLE PROPERTY (REAL PROPERTY))

This Article deals with the taxation of income from immovable property (real property) situated in a Contracting State (the "situs State"). The Article does not grant an exclusive taxing right to the situs State; the situs State is merely given the primary right to tax. However, until such time as Bulgaria provides, with respect to income taxable under this Article, for an election to be subject to tax on a net basis as though such income were business profits attributable to a permanent establishment, the Bulgarian rate of tax may not exceed 10 percent of the gross amount of income derived by a U.S. resident from real property situated in Bulgaria.

Paragraph 1

The first paragraph of Article 6 states the general rule 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. The paragraph specifies that income from real property includes income from agriculture and forestry.

Paragraph 2

The term "real property" is defined in paragraph 2 by reference to the internal law definition in the situs State. In the case of the United States, the term has the meaning given to it by Treas. Reg. section 1.897-1(b). In addition to the statutory definitions in the two Contracting States, the paragraph specifies certain additional classes of property that, regardless of internal law definitions, are within the scope of the term for purposes of the Convention. This expanded definition conforms to that in the OECD Model. The definition of "real property" for purposes of Article 6 is more limited than the expansive definition of "real property" in paragraph 1 of Article 13 (Capital Gains). The Article 13 term includes not only real property as defined in Article 6 but certain other interests in real property.

Paragraph 3

Paragraph 3 makes clear that all forms of income derived from the exploitation of real property are taxable in the Contracting State in which the property is situated. This includes income from any use of real property, including, but not limited to, income from direct use by

the owner (in which case income may be imputed to the owner for tax purposes) and rental income from the letting of real property.

Other income closely associated with real property is covered by other Articles of the Convention, however, and not Article 6. For example, income from the disposition of an interest in real property is not considered "derived" from real property; taxation of that income is addressed in Article 13 (Capital Gains). Interest paid on a mortgage on real property would be covered by Article 11 (Interest). Distributions by a U.S. Real Estate Investment Trust or certain regulated investment companies would fall under Article 13 (Capital Gains) in the case of distributions of U.S. real property gain or Article 10 (Dividends) in the case of distributions treated as dividends. Finally, distributions from a United States Real Property Holding Corporation are not considered to be income from the exploitation of real property; such payments would fall under Article 10 or 13.

Paragraph 4

This paragraph specifies that the basic rule of paragraph 1 (as elaborated in paragraph 3) applies to income from real property of an enterprise. This clarifies that the situs country may tax the real property income (including rental income) of a resident of the other Contracting State in the absence of attribution to a permanent establishment in the situs State. This provision represents an exception to the general rule under Article 7 (Business Profits) that income must be attributable to a permanent establishment in order to be taxable in the situs state. However, if a resident of a Contracting State carries on a business in the other Contracting State through a permanent establishment situated therein and the real property is effectively connected with such permanent establishment, the provisions of Article 7 apply to the real property income. This rule is important in view of the lack of an election to be subject to tax on a net basis with respect to income taxable under this Article under Bulgarian law and the Convention. Accordingly, if a U.S. resident has a permanent establishment in Bulgaria through which the real property income is earned, that income will be taxed on a net basis using the rates and rules of taxation generally applicable to residents of Bulgaria, as such rules may be modified by the Convention.

Paragraph 5

This paragraph contains a special rule limiting the rate of Bulgarian taxation to 10 percent of the gross amount of income derived by a U.S. resident from real property situated in Bulgaria. This special rule applies for as long as U.S. residents are not entitled under Bulgarian law to make an election to compute the tax on income from real property situated in Bulgaria on a net basis as if such income were business profits attributable to a permanent establishment in Bulgaria.

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

Paragraph 1 states 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 business in that other Contracting State through a permanent establishment (as defined in Article 5 (Permanent Establishment)) situated there. When that condition is met, the State in which the permanent establishment is situated may tax the enterprise on the income that is attributable to the permanent establishment.

Although the Convention does not include a definition of "business profits," the term is intended to cover income derived from any trade or business. In accordance with this broad definition, the term "business profits" includes income attributable to notional principal contracts and other financial instruments to the extent that the income is attributable to a trade or business of dealing in such instruments or is otherwise related to a trade or business (as in the case of a notional principal contract entered into for the purpose of hedging currency risk arising from an active trade or business). Any other income derived from such instruments is, unless specifically covered in another article, dealt with under Article 20 (Other Income).

The term "business profits" also includes income derived by an enterprise from the rental of tangible personal property (unless such tangible personal property consists of aircraft, ships or containers, income from which is addressed by Article 8 (International Traffic)). The inclusion of income derived by an enterprise from the rental of tangible personal property in business profits means that such income earned by a resident of a Contracting State can be taxed by the other Contracting State only if the income is attributable to a permanent establishment maintained by the resident in that other State, and, if the income is taxable, it can be taxed only on a net basis. Income from the rental of tangible personal property that is not derived in connection with a trade or business is dealt with in Article 20 (Other Income).

In addition, as a result of the definitions of "enterprise" and "business" in Article 3 (General Definitions), the term includes income derived from the furnishing of personal services. Thus, a consulting firm resident in one State whose employees or partners perform services in the other State through a permanent establishment may be taxed in that other State on a net basis under Article 7, and not under Article 14 (Income from Employment), which applies only to income of employees. With respect to the enterprise's employees themselves, however, their salary remains subject to Article 14.

Because this Article applies to income earned by an enterprise from the furnishing of personal services, the Article also applies to income derived by a partner resident in a Contracting State that is attributable to personal services performed in the other Contracting State through a partnership with a permanent establishment in that other State. Income that may be taxed under this Article includes all income attributable to the permanent establishment in respect of the performance of the personal services carried on by the partnership (whether by the partner himself, other partners in the partnership, or by employees assisting the partners) and any income from activities ancillary to the performance of those services (*e.g.*, charges for facsimile services).

The application of Article 7 to a service partnership may be illustrated by the following example: a partnership has five partners (who agree to split profits equally), four of whom are resident and perform personal services only in Bulgaria at Office A, and one of whom performs personal services at Office B, a permanent establishment in the United States. In this case, the four partners of the partnership resident in Bulgaria may be taxed in the United States in respect of their share of the income attributable to the permanent establishment, Office B. The services giving rise to income which may be attributed to the permanent establishment would include not only the services performed by the one resident partner, but also, for example, if one of the four other partners came to the United States and worked on an Office B matter there, the income in respect of those services. Income from the services performed by the visiting partner would be subject to tax in the United States regardless of whether the visiting partner actually visited or used Office B while performing services in the United States.

Paragraph 2

Paragraph 2 provides rules for the attribution of business profits to a permanent establishment. The Contracting States will attribute to a permanent establishment the profits that

it would have earned had it been a distinct and separate 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.

The "attributable to" concept of paragraph 2 provides an alternative to the analogous but somewhat different "effectively connected" concept in Code section 864(c). Depending upon the circumstances, the amount of income "attributable to" a permanent establishment under Article 7 may be greater or less than the amount of income that would be treated as "effectively connected" to a U.S. trade or business under Code section 864. In particular, in the case of financial institutions, the use of internal dealings to allocate income within an enterprise may produce results under Article 7 that are significantly different than the results under the effectively connected income rules. For example, income from interbranch notional principal contracts may be taken into account under Article 7, notwithstanding that such transactions may be ignored for purposes of U.S. domestic law.

The profits attributable to a permanent establishment may be from sources within or without a Contracting State. However, as stated in paragraph 5 of the Protocol, the business profits attributable to a permanent establishment include only those profits derived from the assets used, risks assumed, and activities performed by, the permanent establishment.

Paragraph 5 of the Protocol confirms that the arm's length method of paragraphs 2 and 3 consists of applying the OECD Transfer Pricing Guidelines, but taking into account the different economic and legal circumstances of a single legal entity (as opposed to separate but associated enterprises). Thus, any of the methods used in the Transfer Pricing Guidelines, including profits methods, may be used as appropriate and in accordance with the Transfer Pricing Guidelines. However, the use of the Transfer Pricing Guidelines applies only for purposes of attributing profits within the legal entity. It does not create legal obligations or other tax consequences that would result from transactions having independent legal significance.

For example, an entity that operates through branches rather than separate subsidiaries generally will have lower capital requirements because all of the assets of the entity are available to support all of the entity's liabilities (with some exceptions attributable to local regulatory restrictions). This is the reason that most commercial banks and some insurance companies operate through branches rather than subsidiaries. The benefit that comes from such lower capital costs must be allocated among the branches in an appropriate manner. This issue does not arise in the case of an enterprise that operates through separate entities, since each entity will have to be separately capitalized or will have to compensate another entity for providing capital (usually through a guarantee).

Under U.S. domestic regulations, internal "transactions" generally are not recognized because they do not have legal significance. In contrast, the rule provided by the Convention is that such internal dealings may be used to attribute income to a permanent establishment in cases where the dealings accurately reflect the allocation of risk within the enterprise. One example is that of global trading in securities. In many cases, banks use internal swap transactions to transfer risk from one branch to a central location where traders have the expertise to manage that particular type of risk. Under the Convention, such a bank may also use such swap transactions as a means of attributing income between the branches, if use of that method is the "best method" within the meaning of Treas. Reg. section 1.482-1(c). The books of a branch will not be respected, however, when the results are inconsistent with a functional analysis. So, for example, income from a transaction that is booked in a particular branch (or home office) will not be treated as attributable to that location if the sales and risk management functions that generate the income are performed in another location.

Because the use of profits methods is permissible under paragraph 2, it is not necessary for the Convention to include a provision corresponding to paragraph 4 of Article 7 of the OECD Model.

Paragraph 3

Paragraph 3 provides that in determining the business profits of a permanent establishment, deductions shall be allowed for the expenses incurred for the purposes of the permanent establishment, ensuring that business profits will be taxed on a net basis. This rule is not limited to expenses incurred exclusively for the purposes of the permanent establishment, but includes expenses incurred for the purposes of the enterprise as a whole, or that part of the enterprise that includes the permanent establishment. Deductions are to be allowed regardless of which accounting unit of the enterprise books the expenses, so long as they are incurred for the purposes of the permanent establishment. For example, a portion of the interest expense recorded on the books of the home office in one State may be deducted by a permanent establishment in the other if properly allocable thereto. The amount of expense that must be allowed as a deduction is determined by applying the arm's length principle. As noted above with respect to paragraph 2 of Article 1 (General Scope), if a deduction would be allowed under the Code in computing the U.S. taxable income, the deduction also is allowed in computing taxable income under the Convention. However, except where the Convention provides for more favorable treatment, a taxpayer cannot take deductions for expenses in computing taxable income under the Convention to a greater extent than would be allowed under the Code where doing so would be inconsistent with the intent of the Code. For example, assume that a Bulgarian taxpayer with a permanent establishment in the United States borrows $100 to purchase U.S. tax exempt bonds, and that the $100 of tax-exempt bonds and the $100 of related debt would be treated as assets and liabilities of the permanent establishment. For purposes of computing the profits attributable to the permanent establishment under the Convention, both the tax exempt interest from the bonds and the interest expense from the related debt would be excluded.

As noted above, paragraph 5 of the Protocol provides that the OECD Transfer Pricing Guidelines apply, by analogy, in determining the profits attributable to a permanent establishment. Accordingly, a permanent establishment may deduct payments made to its head office or another branch in compensation for services performed for the benefit of the branch. The method to be used in calculating that amount will depend on the terms of the arrangements between the branches and head office. For example, the enterprise could have a policy, expressed in writing, under which each business unit could use the services of lawyers employed by the head office. At the end of each year, the costs of employing the lawyers would be charged to each business unit according to the amount of services used by that business unit during the year. Since this appears to be a kind of cost-sharing arrangement and the allocation of costs is based on the benefits received by each business unit, such a cost allocation would be an acceptable means of determining a permanent establishment's deduction for legal expenses. Alternatively, the head office could agree to employ lawyers at its own risk, and to charge an arm's length price for legal services performed for a particular business unit. If the lawyers were under-utilized, and the "fees" received from the business units were less than the cost of employing the lawyers, then the head office would bear the excess cost. If the "fees" exceeded the cost of employing the lawyers, then the head office would keep the excess to compensate it for assuming the risk of employing the lawyers. If the enterprise acted in accordance with this agreement, this method would be an acceptable alternative method for calculating a permanent establishment's deduction for legal expenses.

Paragraph 5 of the Protocol also makes clear that a permanent establishment cannot be funded entirely with debt, but must have sufficient capital to carry on its activities as if it were a distinct and separate enterprise. To the extent that the permanent establishment does not have

such capital, a Contracting State may, for profit attribution purposes, attribute such capital to the permanent establishment in accordance with the arm's length principle and deny an interest deduction to the extent necessary to reflect that capital attribution. The method prescribed by U.S. domestic law for making this attribution is found in Treas. Reg. section 1.882-5. Both section 1.882-5 and the method prescribed in the Convention start from the premise that all of the capital of the enterprise supports all of the assets and risks of the enterprise, and therefore the entire capital of the enterprise must be allocated to its various businesses and offices.

However, section 1.882-5 does not take into account the fact that some assets create more risk for the enterprise than do other assets. An independent enterprise would need less capital to support a perfectly-hedged U.S. Treasury security than it would need to support an equity security or other asset with significant market and/or credit risk. Accordingly, in some cases section 1.882-5 would require a taxpayer to allocate more capital to the United States, and therefore would reduce the taxpayer's interest deduction more, than is appropriate. To address these cases, paragraph 5 of the Protocol allows a taxpayer to apply a more flexible approach that takes into account the relative risk of its assets in the various jurisdictions in which it does business. In particular, in the case of financial institutions other than insurance companies, the amount of capital attributable to a permanent establishment is determined by allocating the institution's total equity between its various offices on the basis of the proportion of the financial institution's risk-weighted assets attributable to each of them. This recognizes the fact that financial institutions are in many cases required to risk-weight their assets for regulatory purposes and, in other cases, will do so for business reasons even if not required to do so by regulators. However, risk-weighting is more complicated than the method prescribed by section 1.882-5. Accordingly, to ease this administrative burden, taxpayers may choose to apply the principles of Treas. Reg. section 1.882-5(c) to determine the amount of capital allocable to its U.S. permanent establishment, in lieu of determining its allocable capital under the risk-weighted capital allocation method provided by the Convention, even if it has otherwise chosen the principles of Article 7 rather than the effectively connected income rules of U.S. domestic law.

Paragraph 4

Paragraph 4 provides that no business profits can be attributed to a permanent establishment merely because it purchases goods or merchandise for the enterprise of which it is a part. This paragraph is essentially identical to paragraph 5 of Article 7 of the OECD Model. This rule applies only to an office that performs functions for the enterprise in addition to purchasing. The income attribution issue does not arise if the sole activity of the office is the purchase of goods or merchandise because such activity does not give rise to a permanent establishment under Article 5 (Permanent Establishment). A common situation in which paragraph 4 is relevant is one in which a permanent establishment purchases raw materials for the enterprise's manufacturing operation conducted outside the United States and sells the manufactured product. 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.

Paragraph 5

Paragraph 5 provides that profits shall be determined by the same method each year, unless there is good reason to change the method used. This rule assures consistent tax treatment over time for permanent establishments. It limits the ability of both the Contracting State and the enterprise to change accounting methods to be applied to the permanent establishment. It does not, however, restrict a Contracting State from imposing additional requirements, such as the rules under Code section 481, to prevent amounts from being duplicated or omitted following a change in accounting method. Such adjustments may be necessary, for example, if the taxpayer switches from using the domestic rules under section 864 in one year to using the rules

of Article 7 in the next. Also, if the taxpayer switches from Convention-based rules to U.S. domestic rules, it may need to meet certain deadlines for making elections that are not necessary when applying the rules of the Convention.

Paragraph 6

Paragraph 6 coordinates the provisions of Article 7 and other provisions of the Convention. Under this paragraph, when business profits include items of income that are dealt with separately under other articles of the Convention, the provisions of those articles will, except when they specifically provide to the contrary, take precedence over the provisions of Article 7. For example, the taxation of dividends will be determined by the rules of Article 10 (Dividends), and not by Article 7, except where, as provided in paragraph 6 of Article 10, the dividend is attributable to a permanent establishment. In the latter case the provisions of Article 7 apply. Thus, an enterprise of one State deriving dividends from the other State may not rely on Article 7 to exempt those dividends from tax at source if they are not attributable to a permanent establishment of the enterprise in the other State. By the same token, if the dividends are attributable to a permanent establishment in the other State, the dividends may be taxed on a net income basis at the source State full corporate tax rate, rather than on a gross basis under Article 10 (Dividends).

As provided in Article 8 (International Traffic), income derived from shipping and air transport activities in international traffic described in that Article is taxable only in the country of residence of the enterprise regardless of whether it is attributable to a permanent establishment situated in the source State.

The Convention incorporates the rule of Code section 864(c)(6). Like the Code section on which it is based, paragraph 5 of the Protocol 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 situated, even if the payment of that income or gain is deferred until after the permanent establishment ceases to exist. This rule applies with respect to Article 7 (Business Profits), paragraph 4 of Article 6 (Income from Immovable Property (Real Property)), paragraph 6 of Article 10 (Dividends), paragraph 5 of Article 11 (Interest), paragraph 4 of Article 12 (Royalties), paragraph 3 of Article 13 (Capital Gains) and paragraph 2 of Article 20 (Other Income).

The effect of this rule can be illustrated by the following example. Assume a company that is a resident of Bulgaria and that maintains a permanent establishment in the United States winds up the permanent establishment's business and sells the permanent establishment's inventory and assets to a U.S. buyer at the end of year 1 in exchange for an interest-bearing installment obligation payable in full at the end of year 3. Despite the fact that Article 13's threshold requirement for U.S. taxation is not met in year 3 because the company has no permanent establishment in the United States, the United States may tax the deferred income payment recognized by the company in year 3.

Relationship to Other Articles

This Article is subject to the saving clause of paragraph 4 of Article 1 (General Scope). Thus, if a citizen of the United States who is a resident of Bulgaria under the treaty 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 4 of Article 22 (Relief from Double Taxation), tax those profits, notwithstanding paragraph 1 of this Article, which would exempt the income from U.S. tax.

The benefits of this Article are also subject to Article 21 (Limitation on Benefits). Thus, an enterprise of Bulgaria and that derives income effectively connected with a U.S. trade or business may not claim the benefits of Article 7 unless the resident carrying on the enterprise qualifies for such benefits under Article 21.

ARTICLE 8 (INTERNATIONAL TRAFFIC)

This Article governs the taxation of profits from the operation of ships and aircraft in international traffic. The term "international traffic" is defined in subparagraph 1(j) of Article 3 (General Definitions).

Paragraph 1

Paragraph 1 provides that profits derived by an enterprise of a Contracting State from the operation in international traffic of ships or aircraft are taxable only in that Contracting State. Because paragraph 6 of Article 7 (Business Profits) defers to Article 8 with respect to shipping income, such income derived by a resident of one of the Contracting States may not be taxed in the other State even if the enterprise has a permanent establishment in that other State. Thus, if a U.S. airline has a ticket office in Bulgaria, Bulgaria may not tax the airline's profits attributable to that office under Article 7. Since entities engaged in international transportation activities normally will have many permanent establishments in a number of countries, the rule avoids difficulties that would be encountered in attributing income to multiple permanent establishments if the income were covered by Article 7 (Business Profits).

Paragraph 2

The income from the operation of ships or aircraft in international traffic that is exempt from tax under paragraph 1 is defined in paragraph 2.

In addition to income derived directly from the operation of ships and aircraft in international traffic, this definition also includes certain items of rental income. First, income of an enterprise of a Contracting State from the rental of ships or aircraft on a full basis (i.e., with crew) is income of the lessor from the operation of ships and aircraft in international traffic and, therefore, is exempt from tax in the other Contracting State under paragraph 1. Also, paragraph 2 encompasses income from the lease of ships or aircraft on a bareboat basis (i.e., without crew) when the income is incidental to other income of the lessor from the operation of ships or aircraft in international traffic. If the income is not incidental to other income of the lessor from the operation of ships or aircraft in international traffic, income from bareboat rentals would constitute business profits.

Paragraph 6 of the Protocol clarifies, consistent with the U.S. Model and the Commentary to Article 8 of the OECD Model, that profits derived by an enterprise from the inland transport of tangible property or passengers within either Contracting State is treated as profits from the operation of ships or aircraft in international traffic if such transport is undertaken as part of international traffic. Thus, if a U.S. shipping company contracts to carry property from Bulgaria to a U.S. city and, as part of that contract, it transports the property by truck from its point of origin to an airport in Bulgaria (or it contracts with a trucking company to carry the property to the airport) the income earned by the U.S. shipping company from the overland leg of the journey would be taxable only in the United States. Similarly, Article 8 also would apply to all of the income derived from a contract for the international transport of goods, even if the goods were transported to the port by a lighter, not by the vessel that carried the goods in international waters.

Finally, certain non-transport activities that are an integral part of the services performed by a transport company, or are ancillary to the enterprise's operation of ships or aircraft in international traffic, are understood to be covered in paragraph 1, though they are not specified in paragraph 2. These include, for example, the provision of goods and services by engineers, ground and equipment maintenance and staff, cargo handlers, catering staff and customer services personnel. Where the enterprise provides such goods to, or performs services for, other enterprises and such activities are directly connected with or ancillary to the enterprise's operation of ships or aircraft in international traffic, the profits from the provision of such goods and services to other enterprises will fall under this paragraph.

For example, enterprises engaged in the operation of ships or aircraft in international traffic may enter into pooling arrangements for the purposes of reducing the costs of maintaining facilities needed for the operation of their ships or aircraft in other countries. For instance, where an airline enterprise agrees (for example, under an International Airlines Technical Pool agreement) to provide spare parts or maintenance services to other airlines landing at a particular location (which allows it to benefit from these services at other locations), activities carried on pursuant to that agreement will be ancillary to the operation of aircraft in international traffic by the enterprise.

Also, advertising that the enterprise may do for other enterprises in magazines offered aboard ships or aircraft that it operates in international traffic or at its business locations, such as ticket offices, is ancillary to its operation of these ships or aircraft. Profits generated by such advertising fall within this paragraph. Income earned by concessionaires, however, is not covered by Article 8. These interpretations of paragraph 1 also are consistent with the Commentary to Article 8 of the OECD Model.

Paragraph 3

Under this paragraph, profits of an enterprise of a Contracting State from the use, maintenance or rental of containers (including equipment for their transport) used for the transport of goods or merchandise are exempt from tax in the other Contracting State, unless those containers are used for transport solely in the other Contracting State. This result obtains under paragraph 3 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. Only income from the use, maintenance or rental of containers that is incidental to other income from international traffic is covered by Article 8 of the OECD Model.

Paragraph 4

This paragraph clarifies that the provisions of paragraphs 1 and 3 also apply to profits derived by an enterprise of a Contracting State 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, airlines from two countries may agree to share the transport of passengers between the two countries. They each will fly the same number of flights per week and share the revenues from that route equally, regardless of the number of passengers that each airline actually transports. Paragraph 4 makes clear that with respect to each carrier the income dealt with in the Article is that carrier's share of the total transport, not the income derived from the passengers actually carried by the airline. This paragraph corresponds to paragraph 4 of Article 8 of the OECD Model.

Relationship to Other Articles

The taxation of gains from the alienation of ships, aircraft or containers is not dealt with in this Article but in paragraphs 4 and 5 of Article 13 (Capital Gains).

As with other benefits of the Convention, the benefit of exclusive residence country taxation under Article 8 is available to an enterprise only if it is entitled to benefits under Article 21 (Limitation on Benefits).

This Article also is subject to the saving clause of paragraph 4 of Article 1 (General Scope) of the Model. Thus, if a citizen of the United States who is a resident of Bulgaria derives profits from the operation of ships or aircraft in international traffic, notwithstanding the exclusive residence country taxation in paragraph 1 of Article 8, the United States may, subject to the special foreign tax credit rules of paragraph 4 of Article 22 (Relief from Double Taxation), tax those profits as part of the worldwide income of the citizen. (This is an unlikely situation, however, because non-tax considerations (e.g., insurance) generally result in shipping activities being carried on in corporate form.)

ARTICLE 9 (ASSOCIATED ENTERPRISES)

This Article incorporates in the Convention the arm's-length principle reflected in the U.S. domestic transfer pricing provisions, particularly Code section 482. It provides that when related enterprises engage in a transaction on terms that are not arm's-length, the Contracting States may make appropriate adjustments to the taxable income and tax liability of such related enterprises to reflect what the income and tax of these enterprises with respect to the transaction would have been had there been an arm's-length relationship between them.

Paragraph 1

This paragraph is essentially the same as its counterpart in the U.S. and OECD Models. It addresses the situation where an enterprise of a Contracting State is related to an enterprise of the other Contracting State, and there are arrangements or conditions imposed between the enterprises in their commercial or financial relations that are different from those that would have existed in the absence of the relationship. Under these circumstances, the Contracting States may adjust the income (or loss) of the enterprise to reflect what it would have been in the absence of such a relationship.

The paragraph identifies the relationships between enterprises that serve as a prerequisite to application of the Article. As the Commentary to the OECD Model makes clear, the necessary element in these relationships is effective control, which is also the standard for purposes of section 482. Thus, the Article applies if an enterprise of one State participates directly or indirectly in the management, control, or capital of the enterprise of the other State. Also, the Article applies if any third person or persons participate directly or indirectly in the management, control, or capital of enterprises of different States. For this purpose, all types of control are included, i.e., whether or not legally enforceable and however exercised or exercisable.

The fact that a transaction is entered into between such related enterprises does not, in and of itself, mean that a Contracting State may adjust the income (or loss) of one or both of the enterprises under the provisions of this Article. If the conditions of the transaction are consistent with those that would be made between independent persons, the income arising from that transaction should not be subject to adjustment under this Article.

Similarly, the fact that associated enterprises may have concluded arrangements, such as cost sharing arrangements or general services agreements, is not in itself an indication that the two enterprises have entered into a non-arm's-length transaction that should give rise to an adjustment under paragraph 1. Both related and unrelated parties enter into such arrangements (e.g., joint venturers may share some development costs). As with any other kind of transaction, when related parties enter into an arrangement, the specific arrangement must be examined to see whether or not it meets the arm's-length standard. In the event that it does not, an appropriate adjustment may be made, which may include modifying the terms of the agreement or re-characterizing the transaction to reflect its substance.

It is understood that the "commensurate with income" standard for determining appropriate transfer prices for intangibles, added to Code section 482 by the Tax Reform Act of 1986, was designed to operate consistently with the arm's-length standard. The implementation of this standard in the section 482 regulations is in accordance with the general principles of paragraph 1 of Article 9 of the Convention, as interpreted by the OECD Transfer Pricing Guidelines.

This Article also permits tax authorities to deal with thin capitalization issues. They may, in the context of Article 9, scrutinize more than the rate of interest charged on a loan between related persons. They also may examine the capital structure of an enterprise, whether a payment in respect of that loan should be treated as interest, and, if it is treated as interest, under what circumstances interest deductions should be allowed to the payor. Paragraph 3 of the Commentary to Article 9 of the OECD Model, together with the U.S. observation set forth in paragraph 15, sets forth a similar understanding of the scope of Article 9 in the context of thin capitalization.

Paragraph 2

When 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 to reflect arm's-length conditions, that other Contracting State is obligated to make a correlative adjustment (sometimes referred to as a "corresponding adjustment") to the tax liability of the related person in that other Contracting State. Although the OECD Model does not specify that the other Contracting State must agree with the initial adjustment before it is obligated to make the correlative adjustment, the Commentary makes clear that the paragraph is to be read that way.

As explained in the Commentary to Article 9 of the OECD Model, Article 9 leaves the treatment of "secondary adjustments" to the laws of the Contracting States. When an adjustment under Article 9 has been made, one of the parties will have in its possession funds that it would not have had at arm's length. The question arises as to how to treat these funds. In the United States the general practice is to treat such funds as a dividend or contribution to capital, depending on the relationship between the parties. Under certain circumstances, the parties may be permitted to restore the funds to the party that would have the funds had the transactions been entered into on arm's length terms, and to establish an account payable pending restoration of the funds. See Rev. Proc. 99-32, 1999-2 C.B. 296.

The Contracting State making a secondary adjustment will take the other provisions of the Convention, where relevant, into account. For example, if the effect of a secondary adjustment is to treat a U.S. corporation as having made a distribution of profits to its parent corporation in Bulgaria, the provisions of Article 10 (Dividends) will apply, and the United States may impose a 5 percent withholding tax on the dividend. Also, if under Article 22 (Relief from Double Taxation) Bulgaria generally gives a credit for taxes paid with respect to such dividends, it would also be required to do so in this case.

The competent authorities are authorized by paragraph 3 of Article 24 (Mutual Agreement Procedure) 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.

If a correlative adjustment is made under paragraph 2, it is to be implemented, pursuant to paragraph 2 of Article 24 (Mutual Agreement Procedure), notwithstanding any time limits or other procedural limitations in the law of the Contracting State making the adjustment. If a taxpayer has entered into a closing agreement (or other written settlement) with the United States prior to bringing a case to the competent authorities, the U.S. competent authority will endeavor only to obtain a correlative adjustment from Bulgaria. See, Rev. Proc. 2006-54, 2006-2 C.B. 1035, Section 7.05.

Relationship to Other Articles

The saving clause of paragraph 4 of Article 1 (General Scope) does not apply to paragraph 2 of Article 9 by virtue of an exception to the saving clause in subparagraph 5(a) of Article 1. Thus, even if the statute of limitations has run, a refund of tax can be made in order to implement a correlative adjustment. Statutory or procedural limitations, however, cannot be overridden to impose additional tax, because paragraph 2 of Article 1 provides that the Convention cannot restrict any statutory benefit.

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 beneficial owner that is a resident of the other Contracting State. The Article provides for full residence country taxation of such dividends and a limited source-State right to tax. Article 10 also provides rules for the imposition of a tax on branch profits by the State of source. Finally, the Article prohibits a State from imposing taxes on a company resident in the other Contracting State, other than a branch profits tax, on undistributed earnings.

Paragraph 1

The right of a shareholder's country of residence to tax dividends arising in the source country is preserved by paragraph 1, which permits a Contracting State to tax its residents on dividends paid to them by a company that is a resident of the other Contracting State. For dividends from any other source paid to a resident, Article 20 (Other Income) grants the State of residence exclusive taxing jurisdiction (other than for dividends attributable to a permanent establishment in the other State).

Paragraph 2

The State of source also may tax dividends beneficially owned by a resident of the other State, subject to the limitations of paragraphs 2 and 4. Paragraph 2 generally limits the rate of withholding tax in the State of source on dividends paid by a company resident in that State to 10 percent of the gross amount of the dividend. If, however, the beneficial owner of the dividend is a company resident in the other State and owns directly shares representing at least 10 percent of the voting power of the company paying the dividend, then the rate of withholding tax in the State of source is limited to 5 percent of the gross amount of the dividend. Shares are considered voting shares if they provide the power to elect, appoint or replace any person vested with the powers ordinarily exercised by the board of directors of a U.S. corporation.

The benefits of paragraph 2 may be granted at the time of payment by means of reduced rate of withholding tax at source. It also is consistent with the paragraph for tax to be withheld at the time of payment at full statutory rates, and the treaty benefit to be granted by means of a subsequent refund so long as such procedures are applied in a reasonable manner.

The determination of whether the ownership threshold for subparagraph 2(a) is met for purposes of the 5 percent maximum rate of withholding tax is made on the date on which entitlement to the dividend is determined. Thus, in the case of a dividend from a U.S. company, the determination of whether the ownership threshold is met generally would be made on the dividend record date.

Paragraph 2 does not affect the taxation of the profits out of which the dividends are paid. The taxation by a Contracting State of the income of its resident companies is governed by the internal law of the Contracting State, subject to the provisions of paragraph 4 of Article 23 (Non-Discrimination).

The term "beneficial owner" 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 that is a resident of one of the States (as determined under Article 4 (Resident)) 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 a nominee on behalf of a resident of that other State would be entitled to benefits. These limitations are confirmed by paragraph 12 of the Commentary to Article 10 of the OECD Model.

Special rules, however, apply to shares that are held through fiscally transparent entities. In that case, the rules of paragraph 6 of Article 1 (General Scope) will apply to determine whether the dividends should be treated as having been derived by a resident of a Contracting State. Residence State principles shall be used to determine who derives the dividend, to assure that the dividends for which the source State grants benefits of the Convention will be taken into account for tax purposes by a resident of the residence State. Source state principles of beneficial ownership shall then apply to determine whether the person who derives the dividends, or another resident of the other Contracting State, is the beneficial owner of the dividend. The source State may conclude that the person who derives the dividend in the residence State is a mere nominee, agent, conduit, etc., for a third country resident and deny benefits of the Convention. If the person who derives the dividend under paragraph 6 of Article 1 would not be treated under the source State's principles for determining beneficial ownership as a nominee, agent, custodian, conduit, etc., that person will be treated as the beneficial owner of the income, profits or gains for purposes of the Convention.

Assume, for instance, that a company resident in Bulgaria pays a dividend to LLC, an entity which is treated as fiscally transparent for U.S. tax purposes but is treated as a company for Bulgarian tax purposes. USCo, a company incorporated in the United States, is the sole interest holder in LLC. Paragraph 6 of Article 1 provides that USCo derives the dividend. Bulgaria's principles of beneficial ownership shall then be applied to USCo. If under the laws of Bulgaria USCo is found not to be the beneficial owner of the dividend, USCo will not be entitled to the benefits of Article 10 with respect to such dividend. The payment may be entitled to benefits, however, if USCo is found to be a nominee, agent, custodian or conduit for a person who is a resident of the United States.

Beyond identifying the person to whom the principles of beneficial ownership shall be applied, the principles of paragraph 6 of Article 1 will also apply when determining whether other requirements, such as the ownership threshold of subparagraph 2(a) have been satisfied.

For example, assume that BulCo, a company that is a resident of Bulgaria, owns all of the outstanding shares in ThirdDE, an entity that is disregarded for U.S. tax purposes that is resident in a third country. ThirdDE owns 100% of the stock of USCo. Bulgaria views ThirdDE as fiscally transparent under its domestic law, and taxes BulCo currently on the income derived by ThirdDE. In this case, BulCo is treated as deriving the dividends paid by USCo under paragraph 6 of Article 1. Moreover, BulCo is treated as owning the shares of USCo directly. The Convention does not address what constitutes direct ownership for purposes of Article 10. As a result, whether ownership is direct is determined under the internal law of the country imposing tax (i.e., the source country) unless the context otherwise requires. Accordingly, a company that holds stock through such an entity will generally be considered to directly own such stock for purposes of Article 10.

This result may change, however, if ThirdDE is regarded as non-fiscally transparent under the laws of Bulgaria. Assuming that ThirdDE is treated as non-fiscally transparent by Bulgaria, the income will not be treated as derived by a resident of Bulgaria for purposes of the Convention. However, ThirdDE may still be entitled to the benefits of the U.S. tax treaty, if any, with its country of residence.

The same principles would apply in determining whether companies holding shares through fiscally transparent entities such as partnerships, trusts, and estates would qualify for benefits. As a result, companies holding shares through such entities may be able to claim the benefits of subparagraph (a) under certain circumstances. The lower rate applies when the company's proportionate share of the shares held by the intermediate entity meets the 10 percent threshold, and the company meets the requirements of Article 1(6) (i.e., the company's country of residence treats the intermediate entity as fiscally transparent) with respect to the dividend. Whether this ownership threshold is satisfied may be difficult to determine and often will require an analysis of the partnership or trust agreement.

Paragraph 3

Paragraph 3 imposes limitations on the rate reductions provided by paragraphs 2 and 4 in the case of dividends paid by a RIC or a REIT.

The first sentence of subparagraph 3(a) provides that dividends paid by a RIC or a REIT are not eligible for the 5 percent rate of withholding tax of subparagraph 2(a).

The second sentence of subparagraph 3(a) provides that the 10 percent maximum rate of withholding tax of subparagraph 2(b) applies to dividends paid by RICs and that the elimination of source-country withholding tax of paragraph 4 applies to dividends paid by RICs and beneficially owned by a pension fund.

The third sentence of subparagraph 3(a) provides that the 10 percent rate of withholding tax also applies to dividends paid by a REIT, and that the elimination of source-country withholding tax of paragraph 4 applies to dividends paid by REITs and beneficially owned by a pension fund, provided that one of the three following conditions is met. First, the beneficial owner of the dividend is an individual or a pension fund, in either case holding an interest of not more than 10 percent in the REIT. Second, the dividend is paid with respect to a class of stock that is publicly traded and the beneficial owner of the dividend is a person holding an interest of not more than 5 percent of any class of the REIT's shares. Third, the beneficial owner of the dividend holds an interest in the REIT of not more than 10 percent and the REIT is "diversified."

A REIT is diversified if the gross value of no single interest in real property held by the REIT exceeds 10 percent of the gross value of the REIT's total interest in real property. Foreclosure property is not considered an interest in real property, and a REIT holding a partnership interest is treated as owning its proportionate share of any interest in real property held by the partnership.

Subparagraph (b) provides that the rules of subparagraph (a) shall also apply to dividends paid by companies resident in Bulgaria that are similar to a RIC or a REIT. Whether companies that are residents of Bulgaria are similar to RICs or REITs will be determined by mutual agreement of the competent authorities.

The restrictions set out above are intended to prevent the use of these entities to gain inappropriate tax benefits. For example, a company resident in Bulgaria that wishes to hold a diversified portfolio of U.S. corporate shares could hold the portfolio directly and would bear a U.S. withholding tax of 10 percent on all of the dividends that it receives. Alternatively, it could hold the same diversified portfolio by purchasing 10 percent or more of the interests in a RIC. If the RIC is a pure conduit, there may be no U.S. tax cost to interposing the RIC in the chain of ownership. Absent the special rule in paragraph 3, such use of the RIC could transform portfolio dividends, taxable in the United States under the Convention at a 10 percent maximum rate of withholding tax, into direct investment dividends taxable at a 5 percent maximum rate of withholding tax.

Similarly, a resident of Bulgaria directly holding U.S. real property would pay U.S. tax upon the sale of the property either at a 30 percent rate of withholding tax on the gross income or at graduated rates on the net income. As in the preceding example, by placing the real property in a REIT, the investor could, absent a special rule, transform income from the sale of real estate into dividend income from the REIT, taxable at the rates provided in Article 10, significantly reducing the U.S. tax that otherwise would be imposed. Paragraph 3 prevents this result and thereby avoids a disparity between the taxation of direct real estate investments and real estate investments made through REIT conduits. In the cases in which paragraph 3 allows a dividend from a REIT to be eligible for the 10 percent rate of withholding tax, the holding in the REIT is not considered the equivalent of a direct holding in the underlying real property.

Paragraph 4

Paragraph 4 provides that, notwithstanding paragraph 2, the State of source will not tax dividends beneficially owned by a pension fund resident in the other Contracting State, unless such dividends are derived from the carrying on of a business by the pension fund or from an associated enterprise that is not itself a pension fund resident in the other Contracting State. For these purposes, the term "pension fund" is defined in subparagraph 1(m) of Article 3 (General Definitions).

The exemption is provided because pension funds normally do not pay tax (either through a general exemption or because reserves for future pension liabilities effectively offset all of the fund's income), and therefore cannot benefit from a foreign tax credit. Moreover, distributions from a pension fund generally do not maintain the character of the underlying income, so the beneficiaries of the pension are not in a position to claim a foreign tax credit when they finally receive the pension, in many cases years after the withholding tax has been paid. Accordingly, in the absence of this rule, the dividends would almost certainly be subject to unrelieved double taxation.

Paragraph 5

Paragraph 5 defines the term dividends broadly and flexibly. The definition is intended to cover all arrangements that yield a return on an equity investment in a corporation as determined under the tax law of the state of source, as well as arrangements that might be developed in the future.

The term includes income from shares, or other corporate rights that are not treated as debt under the law of the source State, that participate in the profits of the company. The term also includes income that is subjected to the same tax treatment as income from shares by the law of the State of source. Thus, a constructive dividend that results from a non-arm's length transaction between a corporation and a related party is a dividend. In the case of the United States the term dividend includes amounts treated as a dividend under U.S. law upon the sale or redemption of shares or upon a transfer of shares in a reorganization. See, e.g., Rev. Rul. 92-85, 1992-2 C.B. 69 (sale of foreign subsidiary's stock to U.S. sister company is a deemed dividend to extent of the subsidiary's and sister company's earnings and profits). Further, a distribution from a U.S. publicly traded limited partnership, which is taxed as a corporation under U.S. law, is a dividend for purposes of Article 10. However, a distribution by a limited liability company is not taxable by the United States under Article 10, provided the limited liability company is not characterized as an association taxable as a corporation under U.S. law.

Finally, a payment denominated as interest that is made by a thinly capitalized corporation may be treated as a dividend to the extent that the debt is recharacterized as equity under the laws of the source State.

Paragraph 6

Paragraph 6 provides a rule for taxing dividends paid with respect to holdings that form part of the business property of a permanent establishment. In such case, the rules of Article 7 (Business Profits) shall apply. Accordingly, the 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 is located, as such rules may be modified by the Convention. An example of dividends paid with respect to the business property of a permanent establishment would be dividends derived by a dealer in stock or securities from stock or securities that the dealer held for sale to customers.

Paragraph 7

The right of a Contracting State to tax dividends paid by a company that is a resident of the other Contracting State is restricted by paragraph 7 to cases in which the dividends are paid to a resident of that Contracting State or are attributable to a permanent establishment in that Contracting State. Thus, a Contracting State may not impose a "secondary" withholding tax on dividends paid by a nonresident company out of earnings and profits from that Contracting State.

The paragraph also restricts the right of a Contracting State to impose corporate level taxes on undistributed profits, other than a branch profits tax. The paragraph does not restrict a State's right to tax its resident shareholders on undistributed earnings of a corporation resident in the other State. Thus, the authority of the United States to impose taxes on subpart F income and on earnings deemed invested in U.S. property, and its tax on income of a passive foreign investment company that is a qualified electing fund is in no way restricted by this provision.

Paragraph 8

Paragraph 8 permits a Contracting State to impose a branch profits tax on a company resident in the other Contracting State. The tax is in addition to other taxes permitted by the Convention. The term "company" is defined in subparagraph 1(e) of Article 3 (General Definitions).

A Contracting State may impose a branch profits tax on a company if the company has income attributable to a permanent establishment in that Contracting State, derives income from real property in that Contracting State that is taxed on a net basis under Article 6 (Income from Immovable Property (Real Property)), or realizes gains taxable in that State under paragraph 1 of Article 13 (Capital Gains). In the case of the United States, the imposition of such tax is limited, however, to the portion of the aforementioned items of income that represents the amount of such income that is the "dividend equivalent amount." This is consistent with the relevant rules under the U.S. branch profits tax, and the term dividend equivalent amount is defined under U.S. law. Section 884 defines the dividend equivalent amount as an amount for a particular year that is equivalent to the income described above that is included in the corporation's effectively connected earnings and profits for that year, after payment of the corporate tax under Article 6, Article 7, or Article 13, reduced for any increase in the branch's U.S. net equity during the year or increased for any reduction in its U.S. net equity during the year. U.S. net equity is U.S. assets less U.S. liabilities. See Treas. Reg. section 1.884-1.

The dividend equivalent amount for any year approximates the dividend that a U.S. branch office would have paid during the year if the branch had been operated as a separate U.S. subsidiary company. If Bulgaria also imposes a branch profits tax, the base of its tax must be limited to an amount that is analogous to the dividend equivalent amount.

As discussed in the Technical Explanation to paragraph 2 of Article 1, consistency principles require that a taxpayer may not use both treaty and Code rules where doing so would thwart the intent of either set of rules. In the context of the branch profits tax, the consistency requirement means that an enterprise that uses the principles of Article 7 to determine its net taxable income also must use those principles in determining the dividend equivalent amount. Similarly, an enterprise that uses U.S. domestic law to determine its net taxable income must also use U.S. domestic law in complying with the branch profits tax. As in the case of Article 7, if an enterprise switches between domestic law and treaty principles from year to year, it will need to make appropriate adjustments or recapture amounts that otherwise might go untaxed.

Subparagraph b) provides that the branch profits tax shall not be imposed at a rate exceeding the direct investment dividend withholding rate of five percent.

Relationship to Other Articles

Notwithstanding the foregoing limitations on source country taxation of dividends, the saving clause of paragraph 4 of Article 1 permits the United States to tax dividends received by its residents and citizens, subject to the special foreign tax credit rules of paragraph 4 of Article 22 (Relief from Double Taxation), as if the Convention had not come into effect.

The benefits of this Article are also subject to the provisions of Article 21 (Limitation on Benefits). Thus, if a resident of the other Contracting State is the beneficial owner of dividends paid by a U.S. corporation, the shareholder must qualify for treaty benefits under at least one of the tests of Article 21 in order to receive the benefits of this Article.

ARTICLE 11 (INTEREST)

Article 11 specifies the taxing jurisdictions over interest arising in one Contracting State and paid to a resident of the other Contracting State.

Paragraph 1

Paragraph 1 generally grants to the State of residence the non-exclusive right to tax interest arising in the other Contracting State and paid to its residents.

Paragraph 2

Paragraph 2 provides that the State of source also may tax the interest, but if the interest is beneficially owned by a resident of the other Contracting State, the rate of tax will be limited to 5 percent of the gross amount of the interest.

The term "beneficial owner" is not defined in the Convention, and is, therefore, defined under the internal law of the State of source. The beneficial owner of the interest for purposes of Article 11 is the person to which the income is attributable under the laws of the source State. Thus, if interest arising in a Contracting State 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 interest is not entitled to the benefits of Article 11. However, interest received by a nominee on behalf of a resident of that other State would be entitled to benefits. These limitations are confirmed by paragraph 9 of the OECD Commentary to Article 11.

Paragraph 3

Paragraph (3) provides for exclusive residence-based taxation in certain cases.

Under subparagraph (a), interest beneficially owned by a Contracting State, a political subdivision, or a local authority thereof (i.e., in the United States, a State or local government), the central bank of that Contracting State or any institution wholly owned by that Contracting State is subject to exclusive residence-based taxation.

Under subparagraph (b), interest beneficially owned by a resident of a Contracting State with respect to debt-claims guaranteed, insured or indirectly financed by the Contracting State, a political subdivision or a local authority thereof, the central bank of that Contracting State or any institution wholly owned by that Contracting State is subject to exclusive residence-based taxation.

Under subparagraph (c), interest beneficially owned by any financial institution, including, for example, a bank or an insurance company, is subject to exclusive residence-based taxation, unless the interest is paid as a part of a back-to-back loan or an arrangement that is economically similar to and has the effect of a back-to-back loan. Paragraph 8 of the Protocol clarifies that the term "back-to-back loan" as used in subparagraph c) means a loan structured to obtain the benefits of subparagraph c) in which the loan is made to a financial institution that in turn lends the funds directly to the intended borrower. By referencing arrangements that are economically similar to, and that have the effect of, a back-to-back loan, paragraph (3)(c) reaches transactions that would not meet the legal requirements of a loan, but would nevertheless serve that purpose economically. For example, the term would encompass securities issued at a discount, or certain swap arrangements intended to operate as the economic equivalent of a back-

to-back loan. In addition, nothing in Article 11 is intended to limit the ability of the Contracting States to enforce their domestic anti-avoidance provisions.

Subparagraph (d) provides for exclusive residence-based taxation of interest beneficially owned by a pension fund resident in the other Contracting State, provided that the interest is not derived from the carrying on of a business, directly or indirectly, by the pension fund.

Paragraph 4

The term "interest" as used in Article 11 is defined in paragraph 4 to include, *inter alia*, income from debt claims of every kind, whether or not secured by a mortgage. Penalty charges for late payment are excluded from the definition of interest. Interest that is paid or accrued subject to a contingency is within the ambit of Article 11. This includes income from a debt obligation carrying the right to participate in profits. The term does not, however, include amounts that are treated as dividends under Article 10 (Dividends).

The term interest also includes amounts subject to the same tax treatment as income from money lent under the law of the State in which the income arises. Thus, for purposes of the Convention, amounts that the United States will treat as interest include (i) the difference between the issue price and the stated redemption price at maturity of a debt instrument (*i.e.*, original issue discount ("OID")), which may be wholly or partially realized on the disposition of a debt instrument (section 1273), (ii) amounts that are imputed interest on a deferred sales contract (section 483), (iii) amounts treated as interest or OID under the stripped bond rules (section 1286), (iv) amounts treated as original issue discount under the below-market interest rate rules (section 7872), (v) a partner's distributive share of a partnership's interest income (section 702), (vi) the interest portion of periodic payments made under a "finance lease" or similar contractual arrangement that in substance is a borrowing by the nominal lessee to finance the acquisition of property, (vii) amounts included in the income of a holder of a residual interest in a REMIC (section 860E), because these amounts generally are subject to the same taxation treatment as interest under U.S. tax law, and (viii) interest with respect to notional principal contracts that are re-characterized as loans because of a "substantial non-periodic payment."

Paragraph 5

Paragraph 5 provides an exception to the rules of paragraphs 1, 2 and 3 in cases where the beneficial owner of the interest carries on business through a permanent establishment in the State of source and the interest is attributable to that permanent establishment. In such cases the provisions of Article 7 (Business Profits) will apply and the State of source will retain the right to impose tax on such interest income.

In the case of a permanent establishment that once existed in the State but that no longer exists, the provisions of paragraph 5 also apply to interest that would be attributable to such a permanent establishment if it did exist in the year of payment or accrual. See the Technical Explanation to Article 7.

Paragraph 6

Paragraph 6 provides a source rule for determining the source of interest that is identical in substance to the interest source rule of the OECD Model. Interest is considered to arise in a Contracting State if paid by a resident of that State. As an exception, interest on a debt incurred in connection with a permanent establishment in one of the States and borne by the permanent establishment is considered to arise in that State. For this purpose, interest is considered to be

borne by a permanent establishment if it is allocable to taxable income of that permanent establishment.

Paragraph 7

Paragraph 7 provides that in cases involving special relationships between the payor and the beneficial owner of interest income, Article 11 applies only to that portion of the total 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 Bulgaria, respectively, with due regard to the other provisions of the Convention. Thus, if the excess amount would be treated under the source country's law as a distribution of profits by a corporation, 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.

The term "special relationship" is not defined in the Convention. In applying this paragraph the United States considers the term to include the relationships described in Article 9, which in turn corresponds to the definition of "control" for purposes of section 482 of the Code.

This paragraph does not address cases where, owing to a special relationship between the payor and the beneficial owner or between both of them and some other person, the amount of the interest is less than an arm's-length amount. In those cases a transaction may be characterized to reflect its substance and interest may be imputed consistent with the definition of interest in paragraph 4. The United States would apply section 482 or 7872 of the Code to determine the amount of imputed interest in those cases.

Paragraph 8

Paragraph 8 provides anti-abuse exceptions to the rules of paragraphs 2 and 3 for two classes of interest payments.

The first class of interest, dealt with in subparagraphs (a) and (b) is so-called "contingent interest." With respect to interest arising in the United States, subparagraph (a) refers to contingent interest of a type that does not qualify as portfolio interest under U.S. domestic law. The cross-reference to the U.S. definition of contingent interest, which is found in section 871(h)(4) of the Code, is intended to ensure that the exceptions of section 871(h)(4)(c) will be applicable. With respect to Bulgaria, such interest is defined in subparagraph (b) as any interest arising in Bulgaria that is determined by reference to the receipts, sales, income, profits or other cash flow of the debtor or a related person, to any change in the value of any property of the debtor or a related person or to any dividend, partnership distribution or similar payment made by the debtor or a related person. Any interest dealt with in subparagraphs (a) and (b) may be taxed in the source State at a rate not exceeding 10 percent of the gross amount of the interest.

The second class of interest is dealt with in subparagraph 8(c). This exception is consistent with the policy of Code sections 860E(e) and 860G(b) that excess inclusions with respect to a real estate mortgage investment conduit (REMIC) should bear full U.S. tax in all cases. Without a full tax at source foreign purchasers of residual interests would have a competitive advantage over U.S. purchasers at the time these interests are initially offered. Also, absent this rule, the U.S. fisc would suffer a revenue loss with respect to mortgages held in a REMIC because of opportunities for tax avoidance created by differences in the timing of taxable and economic income produced by these interests.

Paragraph 9

Paragraph 9 permits a Contracting State to impose its branch level interest tax on a corporation resident in the other Contracting State. The base of this tax is the excess, if any, of the interest deductible in the first-mentioned Contracting State in computing the profits of the corporation that are subject to tax in the first-mentioned Contracting State and either attributable to a permanent establishment in the first-mentioned Contracting State or subject to tax in the first-mentioned Contracting State under Article 6 or Article 13 of the Convention over the interest paid by the permanent establishment or trade or business in the first-mentioned Contracting State. Such excess interest may be taxed as if it were interest arising in the first-mentioned Contracting State and beneficially owned by the corporation resident in the other Contracting State. Thus, such excess interest may be taxed by the Contracting State of source at a rate not to exceed the 5 percent rate provided for in paragraph 2, and shall be exempt from tax by the Contracting State of source if the recipient is described in paragraph 3.

Relationship to Other Articles

Notwithstanding the foregoing limitations on source country taxation of interest, the saving clause of paragraph 4 of Article 1 (General Scope) permits the United States to tax its residents and citizens, subject to the special foreign tax credit rules of paragraph 4 of Article 22 (Relief from Double Taxation), as if the Convention had not come into force.

As with other benefits of the Convention, the benefits of this Article are available to a resident of the other State only if that resident is entitled to those benefits under the provisions of Article 21 (Limitation on Benefits).

Agreement to Reconsider Withholding Rates

The Convention permits positive rates of taxation on interest and royalties. Paragraph 7 of the Protocol evidences the agreement of the Contracting States to reconsider the provisions of Article 11 and Article 12 with respect to interest and royalties arising in Bulgaria where the beneficial owner of the income is a U.S. resident. Such reconsideration is permitted to occur at an appropriate time, consistent with the December 31, 2014 conclusion of the transition period applicable to interest and royalties deemed to arise in Bulgaria that are beneficially owned by a resident of the European Union pursuant to Council Directive 2003/49/EC of 3 June 2003, on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.

ARTICLE 12 (ROYALTIES)

Article 12 provides rules for the taxation of royalties arising in one Contracting State and paid to a resident of the other Contracting State.

Paragraph 1

Paragraph 1 grants the State of residence the non-exclusive right to tax a royalty arising in the other Contracting State and paid to its residents.

Paragraph 2

Paragraph 2 allows the State of source to tax royalties arising in that State. If, however, the beneficial owner of the royalty is a resident of the other Contracting State, the tax may not exceed 5 percent of the gross amount of the royalties.

The term "beneficial owner" is not defined in the Convention, and is, therefore, defined under the internal law of the State of source. The beneficial owner of the royalty for purposes of Article 12 is the person to which the income is attributable under the laws of the source State. Thus, if a royalty arising in a Contracting State 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 royalty is not entitled to the benefits of Article 12. However, a royalty received by a nominee on behalf of a resident of that other State would be entitled to benefits. These limitations are confirmed by paragraph 4 of the OECD Commentary to Article 12.

Paragraph 3

The term "royalties" as used in this Article means:

Paragraph 3 defines the term "royalties," as used in Article 12, to include any consideration for the use of, or the right to use, any copyright of literary, artistic, scientific or other work (including cinematographic films and films, tapes or other means of image or sound reproduction for radio or television broadcasting), any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial, or scientific experience. The term "royalties" also includes gain derived from the alienation of any right or property that would give rise to royalties, to the extent the gain is contingent on the productivity, use, or further alienation thereof. Gains that are not so contingent are dealt with under Article 13 (Capital Gains). The term "royalties," however, does not include income from leasing personal property.

The term royalties is defined in the Convention and therefore is generally independent of domestic law. Certain terms used in the definition are not defined in the Convention, but these may be defined under domestic tax law. For example, the term "secret process or formulas" is found in the Code, and its meaning has been elaborated in the context of sections 351 and 367. See Rev. Rul. 55- 17, 1955-1 C.B. 388; Rev. Rul. 64-56, 1964-1 C.B. 133; Rev. Proc. 69- 19, 1969-2 C.B. 301.

Consideration for the use or right to use cinematographic films, or works on film, tape, or other means of reproduction in radio or television broadcasting is specifically included in the definition of royalties. It is intended that, with respect to any subsequent technological advances in the field of radio or television broadcasting, consideration received for the use of such technology will also be included in the definition of royalties.

If an artist who is resident in one Contracting State records a performance in the other Contracting State, retains a copyrighted interest in a recording, and receives payments for the right to use the recording based on the sale or public playing of the recording, then the right of such other Contracting State to tax those payments is governed by Article 12. See Boulez v. Commissioner, 83 T.C. 584 (1984), aff'd, 810 F.2d 209 (D.C. Cir. 1986). By contrast, if the artist earns in the other Contracting State income covered by Article 16 (Entertainers and Sportsmen), for example, endorsement income from the artist's attendance at a film screening, and if such income also is attributable to one of the rights described in Article 12 (*e.g.*, the use of the artist's photograph in promoting the screening), Article 16 and not Article 12 is applicable to such income.

Computer software generally is protected by copyright laws around the world. Under the Convention, consideration received for the use, or the right to use, computer software is treated either as royalties or as business profits, depending on the facts and circumstances of the transaction giving rise to the payment.

The primary factor in determining whether consideration received for the use, or the right to use, computer software is treated as royalties or as business profits is the nature of the rights transferred. See Treas. Reg. section 1.861-18. The fact that the transaction is characterized as a license for copyright law purposes is not dispositive. For example, a typical retail sale of "shrink wrap" software generally will not be considered to give rise to royalty income, even though for copyright law purposes it may be characterized as a license.

The means by which the computer software is transferred are not relevant for purposes of the analysis. Consequently, if software is electronically transferred but the rights obtained by the transferee are substantially equivalent to rights in a program copy, the payment will be considered business profits.

The term "industrial, commercial, or scientific experience" (sometimes referred to as "know-how") has the meaning ascribed to it in paragraph 11 *et seq.* of the Commentary to Article 12 of the OECD Model. Consistent with that meaning, the term may include information that is ancillary to a right otherwise giving rise to royalties, such as a patent or secret process.

Know-how also may include, in limited cases, technical information that is conveyed through technical or consultancy services. It does not include general educational training of the user's employees, nor does it include information developed especially for the user, such as a technical plan or design developed according to the user's specifications. Thus, as provided in paragraph 11.4 of the Commentary to Article 12 of the OECD Model, the term "royalties" does not include payments received as consideration for after-sales service, for services rendered by a seller to a purchaser under a warranty, or for pure technical assistance.

The term "royalties" also does not include payments for professional services (such as architectural, engineering, legal, managerial, medical, software development services). For example, income from the design of a refinery by an engineer (even if the engineer employed know-how in the process of rendering the design) or the production of a legal brief by a lawyer is not income from the transfer of know-how taxable under Article 12, but is income from services taxable under either Article 7 (Business Profits) or Article 14 (Income from Employment). Professional services may be embodied in property that gives rise to royalties, however. Thus, if a professional contracts to develop patentable property and retains rights in the resulting property under the development contract, subsequent license payments made for those rights would be royalties.

Paragraph 4

This paragraph provides an exception to the manner of allocating taxing rights specified in paragraphs 1 and 2 in cases where the beneficial owner of the royalties carries on business through a permanent establishment in the State of source and the royalties are attributable to that permanent establishment. In such cases the provisions of Article 7 (Business Profits) will apply.

The provisions of paragraph 5 of the Protocol, regarding Article 7 (Business Profits), apply to this paragraph. For example, royalty income that is attributable to a permanent establishment and that accrues during the existence of the permanent establishment, but is received after the permanent establishment no longer exists, remains taxable under the provisions of Article 7 (Business Profits), and not under this Article.

Paragraph 5

Paragraph 5 contains a source rule for determining the source of royalties. Under paragraph 5, royalties are treated as arising in a Contracting State if paid by a resident of that

State. As an exception, royalties that are attributable to a permanent establishment in a Contracting State and borne by the permanent establishment are considered to arise in that State. Where, however, the payor of the royalties is not a resident of either Contracting State, and the royalties are not borne by a permanent establishment in either Contracting State, but the royalties relate to the use of, or the right to use, in one of the Contracting States, any property or right described in paragraph 3, the royalties are deemed to arise in that State.

Paragraph 6

Paragraph 6 provides that in cases involving special relationships between the payor and beneficial owner of royalties, Article 12 applies only to the extent the royalties would have been paid absent such special relationships (i.e., an arm's-length royalty). Any excess amount of royalties paid remains taxable according to the laws of the two Contracting States, with due regard to the other provisions of the Convention. If, for example, the excess amount is treated as a distribution of corporate profits under domestic law, such excess amount will be taxed as a dividend rather than as royalties, but the tax imposed on the dividend payment will be subject to the rate limitations of paragraph 2 of Article 10 (Dividends).

Relationship to Other Articles

Notwithstanding the foregoing limitations on source country taxation of royalties, the saving clause of paragraph 4 of Article 1 (General Scope) permits the United States to tax its residents and citizens, subject to the special foreign tax credit rules of paragraph 4 of Article 22 (Relief from Double Taxation), as if the Convention had not come into force.

As with other benefits of the Convention, the benefits of Article 12 are available to a resident of the other State only if that resident is entitled to those benefits under Article 21 (Limitation on Benefits).

Agreement to Reconsider Withholding Rates

The Convention permits positive rates of taxation on interest and royalties. Paragraph 7 of the Protocol evidences the agreement of the Contracting States to reconsider the provisions of Article 11 and Article 12 with respect to interest and royalties arising in Bulgaria where the beneficial owner of the income is a U.S. resident. Such reconsideration is permitted to occur at an appropriate time, consistent with the December 31, 2014 conclusion of the transition period applicable to interest and royalties deemed to arise in Bulgaria that are beneficially owned by a resident of the European Union pursuant to Council Directive 2003/49/EC of 3 June 2003, on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.

ARTICLE 13 (CAPITAL GAINS)

Article 13 assigns either primary or exclusive taxing jurisdiction over gains from the alienation of property to the State of residence or the State of source.

Paragraph 1

Paragraph 1 of Article 13 preserves the non-exclusive right of the State of source to tax gains attributable to the alienation of real property situated in that State. The paragraph therefore permits the United States to apply section 897 of the Code to tax gains derived by a resident of Bulgaria that are attributable to the alienation of real property situated in the United States (as

defined in paragraph 2). Gains attributable to the alienation of real property include gains from any other property that is treated as a real property interest within the meaning of paragraph 2.

Paragraph 1 refers to gains "attributable to the alienation of immovable property (real property)" rather than the OECD Model phrase "gains from the alienation" to clarify that the United States will look through distributions made by a REIT and certain RICs. Accordingly, distributions made by a REIT or certain RICs are taxable under paragraph 1 of Article 13 (not under Article 10 (Dividends)) when they are attributable to gains derived from the alienation of real property.

Paragraph 2

This paragraph defines the term "immovable property (real property) situated in the other Contracting State." The term includes real property referred to in Article 6 (i.e., an interest in the real property itself), a "United States real property interest" (when the United States is the other Contracting State under paragraph 1), and, as specified in paragraph 2(c), an equivalent interest in immovable property (real property) situated in Bulgaria.

Under section 897(c) of the Code the term "United States real property interest" includes shares in a U.S. corporation that owns sufficient U.S. real property interests to satisfy an asset-ratio test on certain testing dates. The term also includes certain foreign corporations that have elected to be treated as U.S. corporations for this purpose. Section 897(i).

Section 897(c)(3) provides that, in certain situations stock regularly traded on an established securities market will not be treated as a U.S. real property interest, even if the stock derives its value primarily from U.S. real property. With respect to Bulgaria, subparagraph 2(c)(i) of Article 13, provides an analogous carve-out in the case of stock regularly traded on an established securities market. The term "established securities market" is defined in paragraph 9 of the Protocol to mean a national securities exchange which is officially recognized, sanctioned, or supervised by a governmental authority as well as an over the counter market. An over the counter market is any market reflected by the existence of an interdealer quotation system. An interdealer quotation system is any system of general circulation to brokers and dealers which regularly disseminates quotations of stocks and securities by identified brokers or dealers, other than by quotation sheets which are prepared and distributed by a broker or dealer in the regular course of business and which contain only quotations of such broker or dealer. This definition is consistent with the regulations under section 897.

Paragraph 3

Paragraph 3 of Article 13 deals with the taxation of certain gains from the alienation of movable property forming part of the business property of a permanent establishment that an enterprise of a Contracting State has in the other Contracting State. This also includes gains from the alienation of such a permanent establishment (alone or with the whole enterprise). Such gains may be taxed in the State in which the permanent establishment is located.

A resident of Bulgaria that is a partner in a partnership doing business in the United States generally will have a permanent establishment in the United States as a result of the activities of the partnership, assuming that the activities of the partnership rise to the level of a permanent establishment. Rev. Rul. 91-32, 1991-1 C.B. 107. Further, under paragraph 3, the United States generally may tax a partner's distributive share of income realized by a partnership on the disposition of movable property forming part of the business property of the partnership in the United States.

The gains subject to paragraph 3 may be taxed in the State in which the permanent establishment is located, regardless of whether the permanent establishment exists at the time of the alienation. This rule incorporates the rule of section 864(c)(6) of the Code. Accordingly, income that is attributable to a permanent establishment, but that is deferred and received after the permanent establishment no longer exists, may nevertheless be taxed by the State in which the permanent establishment was located.

Paragraph 4

This paragraph limits the taxing jurisdiction of the State of source with respect to gains from the alienation of ships or aircraft operated in international traffic by the enterprise alienating the ship or aircraft and from property (other than real property) pertaining to the operation or use of such ships or aircraft.

Under paragraph 4, such income is taxable only in the Contracting State in which the alienator is resident. Notwithstanding paragraph 3, the rules of this paragraph apply even if the income is attributable to a permanent establishment maintained by the enterprise in the other Contracting State. This result is consistent with the allocation of taxing rights under Article 8 (International Traffic).

Paragraph 5

Paragraph 5 provides a rule similar to paragraph 4 with respect to gains from the alienation of containers and related personal property. Such gains derived by an enterprise of a Contracting State shall be taxable only in that Contracting State unless the containers were used for the transport of goods or merchandise solely within the other Contracting State. The other Contracting State may not tax such gain even if it is attributable to a permanent establishment maintained by the enterprise in that other Contracting State.

Paragraph 6

Paragraph 6 provides that, if certain conditions are met, a Contracting State can tax gains from the alienation of shares of a resident company that are derived by a resident of the other Contracting State. This provision permits Bulgaria to continue to impose its tax on the gain derived by U.S. residents on the alienation of shares in Bulgarian companies in a narrow set of cases. The first requirement is that the alienation occurs within 12 months of the date that the shares are acquired. The second requirement is that the recipient of the gain must have owned, directly or indirectly, at least 25 percent of the capital of the company at some time within the 12-month period preceding the alienation. Finally, the provision provides that a Contracting State may not in any case tax gains derived by a resident of the other Contracting State from the alienation of shares of stock of public companies traded on an established securities market.

As described above, the term "established securities market" is a national securities exchange which is officially recognized, sanctioned, or supervised by a governmental authority as well as an over the counter market. An over the counter market is any market reflected by the existence of an interdealer quotation system, and an interdealer quotation system is any system of general circulation to brokers and dealers which regularly disseminates quotations of stocks and securities by identified brokers or dealers, other than by quotation sheets which are prepared and distributed by a broker or dealer in the regular course of business and which contain only quotations of such broker or dealer.

The United States will treat gain taxed by Bulgaria under this paragraph as of Bulgarian source to the extent necessary to permit a credit for the Bulgarian tax, subject to the limitations of U.S. law.

Paragraph 6 is reciprocal. If the United States were to introduce such a tax, it could be imposed in accordance with the rules of this paragraph.

Paragraph 7

Paragraph 7 clarifies the interrelationship between Articles 12 (Royalties) and 13 with respect to certain gains treated as royalties. Under subparagraph 3(b) of Article 12, the term royalties includes gain derived from the alienation of property that would give rise to royalties, to the extent the gain is contingent on the productivity, use, or further alienation thereof. Therefore, such royalties are governed by the provisions of Article 12 and not by this Article.

Paragraph 8

Paragraph 8 grants to the State of residence of the alienator the exclusive right to tax gains from the alienation of property other than property referred to in paragraphs 1 through 7. For example, gain derived from shares, other than shares described in paragraphs 2, 3, or 6, debt instruments and various financial instruments, may be taxed only in the State of residence, to the extent such income is not otherwise characterized as income taxable under another article (e.g., Article 10 (Dividends) or Article 11 (Interest)). Similarly gain derived from the alienation of tangible personal property, other than tangible personal property described in paragraph 3, may be taxed only in the State of residence of the alienator.

Gains derived by a resident of a Contracting State from real property located in a third state are not taxable in the other Contracting State, even if the sale is attributable to a permanent establishment located in the other Contracting State.

Relationship to Other Articles

Notwithstanding the foregoing limitations on taxation of certain gains by the State of source, the saving clause of paragraph 4 of Article 1 (General Scope) permits the United States to tax its citizens and residents as if the Convention had not come into effect. Thus, any limitation in this Article on the right of the United States to tax gains does not apply to gains of a U.S. citizen or resident.

The benefits of this Article are also subject to the provisions of Article 21 (Limitation on Benefits). Thus, only a resident of a Contracting State that satisfies one of the conditions in Article 21 is entitled to the benefits of this Article.

ARTICLE 14 (INCOME FROM EMPLOYMENT)

Article 14 apportions taxing jurisdiction over remuneration derived by a resident of a Contracting State as an employee between the States of source and residence.

Paragraph 1

The general rule of Article 14 is contained in paragraph 1. Remuneration derived by a resident of a Contracting State as an employee may be taxed by the State of residence, and the remuneration also may be taxed by the other Contracting State to the extent derived from employment exercised (*i.e.*, services performed) in that other Contracting State. Paragraph 1 also provides that the more specific rules of Articles 15 (Directors' Fees), 17 (Pensions, Social Security Payments, Annuities, Alimony, and Child Support), and 18 (Government Service) 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 under Article 14, it may not have the right

to tax that income under the Convention if the income is described, for example, in Article 17 (Pensions, Social Security Payments, Annuities, Alimony, and Child Support) and is not taxable in the State of source under the provisions of that article.

Article 14 applies to any form of compensation for employment, including payments in kind. Paragraph 1.1 of the Commentary to Article 16 of the OECD Model now confirms that interpretation.

Consistent with section 864(c)(6) of the Code, Article 14 also applies regardless of the timing of actual payment for services. Consequently, a person who receives the right to a future payment in consideration for services rendered in a Contracting State would be taxable in that State even if the payment is received at a time when the recipient is a resident of the other Contracting State. Thus, a bonus paid to a resident of a Contracting State with respect to services performed in the other Contracting State with respect to a particular taxable year would be subject to Article 14 even if it was paid after the close of the year. An annuity received for services performed in a taxable year could be subject to Article 14 despite the fact that it was paid in subsequent years. In that case, it would be necessary to determine whether the payment constitutes deferred compensation, taxable under Article 14, or a qualified pension subject to the rules of Article 17 (Pensions, Social Security Payments, Annuities, Alimony, and Child Support). Article 14 also applies to income derived from the exercise of stock options granted with respect to services performed in the host State, even if those stock options are exercised after the employee has left the source country. If Article 14 is found to apply, whether such payments were taxable in the State where the employment was exercised would depend on whether the tests of paragraph 2 were satisfied in the year in which the services to which the payment relates were performed.

Paragraph 2

Paragraph 2 sets forth an exception to the general rule that employment income may be taxed in the State where it is exercised. Under paragraph 2, the State where the employment is exercised may not tax the income from the employment if three conditions are satisfied: (a) 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 during the relevant taxable year (i.e., in the United States, the calendar year in which the services are performed); (b) the remuneration is paid by, or on behalf of, an employer who is not a resident of that other Contracting State; and (c) the remuneration is not borne as a deductible expense by a permanent establishment that the employer has in that other State. In order for the remuneration to be exempt from tax in the source State, all three conditions must be satisfied. This exception is identical to that set forth in the OECD Model.

The 183-day period in condition (a) is to be measured using the "days of physical presence" method. Under this method, the days that are counted include any day in which a part of the day is spent in the host country. (Rev. Rul. 56-24, 1956-1 C.B. 851.) Thus, days that are counted include the days of arrival and departure; weekends and holidays on which the employee does not work but is present within the country; vacation days spent in the country before, during or after the employment period, unless the individual's presence before or after the employment can be shown to be independent of his presence there for employment purposes; and time during periods of sickness, training periods, strikes, etc., when the individual is present but not working. If illness prevented the individual from leaving the country in sufficient time to qualify for the benefit, those days will not count. Also, any part of a day spent in the host country while in transit between two points outside the host country is not counted. If the individual is a resident of the host country for part of the taxable year concerned and a non-resident for the remainder of the year, the individual's days of presence as a resident do not count for purposes of determining whether the 183-day period is exceeded.

Conditions (b) and (c) are intended to ensure that a Contracting State will not be required to allow a deduction to the payor for compensation paid and at the same time to exempt the employee on the amount received. Accordingly, if a foreign person pays the salary of an employee who is employed in the host State, but a host State corporation or permanent establishment reimburses the payor with a payment that can be identified as a reimbursement, neither condition (b) nor (c), as the case may be, will be considered to have been fulfilled.

The reference to remuneration "borne by" a permanent establishment is understood to encompass all expenses that economically are incurred and not merely expenses that are currently deductible for tax purposes. Accordingly, the expenses referred to include expenses that are capitalizable as well as those that are currently deductible. Further, salaries paid by residents that are exempt from income taxation may be considered to be borne by a permanent establishment notwithstanding the fact that the expenses will be neither deductible nor capitalizable since the payor is exempt from tax.

Paragraph 3

Paragraph 3 contains a special rule applicable to remuneration for services performed by 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 State of residence of the employee if the services are performed as a member of the crew of the ship or aircraft or as other personnel regularly employed to serve aboard the ship or aircraft. In the case of a cruise ship, for example, paragraph 3 applies to the crew and others, such as entertainers, lecturers, etc., employed by the shipping company to serve on the ship throughout its voyage. The use of the phrase "regularly employed to serve" 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.

Relationship to Other Articles

If a U.S. citizen who is resident in Bulgaria performs services as an employee in the United States and meets the conditions of paragraph 2 for source country exemption, he nevertheless is taxable in the United States by virtue of the saving clause of paragraph 4 of Article 1 (General Scope), subject to the special foreign tax credit rule of paragraph 4 of Article 22 (Relief from Double Taxation).

ARTICLE 15 (DIRECTORS' FEES)

This Article provides that a Contracting State may tax the fees and other compensation 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 member of the board of directors or a functionally similar body. This rule is an exception to the more general rules of Articles 7 (Business Profits) and 14 (Income from Employment). Thus, for example, in determining whether a director's fee paid to a non-employee director is subject to tax in the country of residence of the corporation, it is not relevant to establish whether the fee is attributable to a permanent establishment in that State.

Under this Article, 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. This provision of the Convention is identical in substance to the analogous provision in the OECD Model.

ARTICLE 16 (ENTERTAINERS AND SPORTSMEN)

This Article deals with the taxation in a Contracting State of 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 one who performs 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, in some circumstances, over those of Articles 7 (Business Profits) and 14 (Income from Employment).

This Article applies only with respect to the income of entertainers 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 7 and 14. In addition, except as provided in paragraph 2, income earned by juridical persons is not covered by Article 16.

Paragraph 1

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. Under the paragraph, income derived by an individual resident of a Contracting State from activities as an entertainer or sportsman exercised in the other Contracting State may be taxed in that other State if the amount of the gross receipts derived by the performer exceeds $15,000 (or its equivalent in Bulgarian currency) for the taxable year. The $15,000 includes expenses reimbursed to the individual or borne on his behalf. If the gross receipts exceed $15,000, the full amount, not just the excess, may be taxed in the State of performance.

This Convention introduces a monetary threshold to distinguish between two groups of entertainers and athletes -- those who are paid relatively 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 relatively modest amounts and are, therefore, not easily distinguishable from those who earn other types of personal service income.

Tax may be imposed under paragraph 1 even if the performer would have been exempt from tax under Article 7 (Business Profits) or 14 (Income from Employment). On the other hand, if the performer would be exempt from host-country tax under Article 16, but would be taxable under either Article 7 or 14, tax may be imposed under either of those Articles. Thus, for example, if a performer derives remuneration from his activities in an independent capacity, and the performer does not have a permanent establishment in the host State, he may be taxed by the host State in accordance with Article 16 if his remuneration exceeds $15,000 annually, despite the fact that he generally would be exempt from host State taxation under Article 7. However, a performer who receives less than the $15,000 threshold amount and therefore is not taxable under Article 16 nevertheless may be subject to tax in the host country under Article 7 or 14 if the tests for host-country taxability under the relevant Article are met. For example, if an entertainer who is an independent contractor earns $14,000 of income in a State for the calendar year, but the income is attributable to his permanent establishment in the State of performance, that State may tax his income under Article 7.

Since it frequently is not possible to know until year-end whether the income an entertainer or sportsman derived from performances in a Contracting State will exceed $15,000, nothing in the Convention precludes that Contracting State from withholding tax during the year and refunding it after the close of the year if the taxability threshold has not been met.

As explained in paragraph 9 of the Commentary to Article 17 of the OECD Model, Article 16 of the Convention applies to all income connected with a performance by the entertainer, such as appearance fees, award or prize money, and a share of the gate receipts. Income derived from a Contracting State by a performer who is a resident of the other Contracting State 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, such as Article 12 (Royalties) or Article 7 (Business Profits). For example, if an entertainer receives royalty income from the sale of live recordings, the royalty income would be subject to the provisions of Article 12, even if the performance was conducted in the source country, although the entertainer could be taxed in the source country with respect to income from the performance itself under Article 16 if the dollar threshold is exceeded.

In determining whether income falls under Article 16 or another article, the controlling factor will be whether the income in question is predominantly attributable to the performance itself or to other activities or property rights. For instance, a fee paid to a performer for endorsement of a performance in which the performer will participate would be considered to be so closely associated with the performance itself that it normally would fall within Article 16. Similarly, a sponsorship fee paid by a business in return for the right to attach its name to the performance would be so closely associated with the performance that it would fall under Article 16 as well. As indicated in paragraph 9 of the Commentary to Article 17 of the OECD Model, however, a cancellation fee would not be considered to fall within Article 16 but would be dealt with under Article 7 (Business Profits) or 14 (Income from Employment).

As indicated in paragraph 4 of the Commentary to Article 17 of the OECD Model, where an individual fulfills a dual role as performer and non-performer (such as a player-coach or an actor-director), but his role in one of the two capacities is negligible, the predominant character of the individual's activities should control the characterization of those activities. In other cases there should be an apportionment between the performance-related compensation and other compensation.

Consistent with Article 14 (Income from Employment), Article 16 also applies regardless of the timing of actual payment for services. Thus, a bonus paid to a resident of a Contracting State with respect to a performance in the other Contracting State during a particular taxable year would be subject to Article 16 even if it was paid after the close of the year. The determination as to whether the $15,000 threshold has been exceeded is determined separately with respect to each year of payment. Accordingly, if an actor who is a resident of one Contracting State receives residual payments over time with respect to a movie that was filmed in the other Contracting State, the payments do not have to be aggregated from one year to another to determine whether the total payments have finally exceeded $15,000. Otherwise, residual payments received many years later could retroactively subject all earlier payments to tax by the other Contracting State.

Paragraph 2

Paragraph 2 is intended to address the potential for circumvention of the rule in paragraph 1 when a performer's income does not accrue directly to the performer himself, but to another person. Foreign performers frequently 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 circumvention of paragraph 1 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 performance (a "star company"). The performer may act as an "employee," receive a modest salary, and arrange to receive the

remainder of the income from his performance from the company in another form or at a later time. In such case, absent the provisions of paragraph 2, the income arguably could escape host-country tax because the company earns business profits but has no permanent establishment in that country. The performer may largely or entirely escape host-country tax by receiving only a small salary, perhaps small enough to place him below the dollar threshold in paragraph 1. The performer might arrange to receive further payments in a later year, when he is not subject to host-country tax, perhaps as dividends or liquidating distributions.

Paragraph 2 seeks to prevent this type of abuse while at the same time protecting the taxpayers' rights to the benefits of the Convention when there is a legitimate employee-employer relationship between the performer and the person providing his services. Under paragraph 2, when the income accrues to a person other than the performer, 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 income from employment (Article 14), but only if one of two conditions is met. The first condition is that the contract pursuant to which the personal activities are performed designates the entertainer or sportsman (by name or description). The second condition is that the contract allows the other party to the contract (or a person other than the entertainer, sportsman or the person to whom the income accrues) to designate the individual who is to perform the personal activities. This rule is consistent with the U.S. domestic law provision characterizing income from certain personal service contracts as foreign personal holding company income.

The premise of this rule is that, in a case where a performer is using another person in an attempt to circumvent the provisions of paragraph 1, the recipient of the services of the performer would contract with a person other than that performer (*i.e.*, a company employing the performer) only if the recipient of the services were certain that the performer himself would perform the services (i.e., the contract mentioned the performer by name or description or else allowed the recipient of the services to designate who is to perform the services). If instead the person to whom the income accrues is allowed to designate the individual who is to perform the services, then likely that person is a service company not formed to circumvent the provisions of paragraph 1. The following example illustrates the operation of this rule.

Example. Company O, a resident of Bulgaria, is engaged in the business of operating an orchestra. Company O enters into a contract with Company A pursuant to which Company O agrees to carry out two performances in the United States in consideration of which Company A will pay Company O $200,000. The contract designates two individuals, a conductor and a flutist, that must perform as part of the orchestra, and allows Company O to designate the other members of the orchestra. Because the contract mentions by name the conductor and the flutist, the portion of the $200,000 that is attributable to the personal services of the conductor and the flutist may be taxed by the United States pursuant to paragraph 2. However, because Company A is not allowed to designate the other performers the remaining portion of the $200,000, is not subject to tax by the United States pursuant to paragraph 2.

In cases where paragraph 2 is applicable, the income of the "employer" may be subject to tax in the host Contracting State even if it has no permanent establishment in the host country. Taxation under paragraph 2 is on the person providing the services of the performer. This paragraph does not affect the rules of paragraph 1, which apply to the performer himself. The income taxable by virtue of paragraph 2 is reduced to the extent of salary payments to the performer, which fall 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 performer) if that other person has control over, or the right to receive, gross income in respect of the services of the performer.

Pursuant to Article 1 (General Scope) the Convention only applies to persons who are residents of one of the Contracting States. Thus, income of a star company that is not a resident of one of the Contracting States would not be eligible for the benefits of the Convention.

Relationship to other Articles

This Article is subject to the provisions of the saving clause of paragraph 4 of Article 1 (General Scope). Thus, if an entertainer or a sportsman who is resident in Bulgaria 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 4 of Article 22 (Relief from Double Taxation). In addition, benefits of this Article are subject to the provisions of Article 21 (Limitation on Benefits).

ARTICLE 17 (PENSIONS, SOCIAL SECURITY, ANNUITIES, ALIMONY, AND CHILD SUPPORT)

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

Paragraph 1

Paragraph 1 provides that distributions from pensions and other similar remuneration beneficially owned by a resident of a Contracting State in consideration of past employment are taxable only in the State of residence of the beneficiary. The term "pensions and other similar remuneration" includes both periodic and single sum payments.

The phrase "pensions and other similar remuneration" is intended to encompass payments made by qualified private retirement plans. In the United States, the plans encompassed by paragraph 1 include: qualified plans under section 401(a), individual retirement plans (including individual retirement plans that are part of a simplified employee pension plan that satisfies section 408(k), individual retirement accounts and section 408(p) accounts), section 403(a) qualified annuity plans, and section 403(b) plans. Distributions from section 457 plans may also fall under Paragraph 1 if they are not paid with respect to government services covered by Article 18.

Pensions in respect of government services covered by Article 18 are not covered by this paragraph. They are covered either by paragraph 2 of this Article, if they are in the form of social security benefits, or by paragraph 2 of Article 18 (Government Service). Thus, Article 18 generally covers section 457, 401(a), 403(b) plans established for government employees, and the Thrift Savings Plan (section 7701(j)).

Paragraph 2

The treatment of social security benefits is dealt with in paragraph 2. This paragraph provides that, notwithstanding the provision of paragraph 1 under which private pensions are taxable exclusively in the State of residence of the beneficial owner, payments made by one of the Contracting States under the provisions of its social security or similar legislation to a resident of Bulgaria or to a citizen of the United States will be taxable only in the Contracting State making the payment. The reference to U.S. citizens is necessary to ensure that a social security payment by Bulgaria to a U.S. citizen who is not resident in the United States will not be taxable by the United States.

This paragraph applies to social security beneficiaries whether they have contributed to the system as private sector or Government employees. The phrase "similar legislation" is intended to refer to United States tier 1 Railroad Retirement benefits.

Paragraph 3

Under paragraph 3, annuities that are derived and beneficially owned by a resident of a Contracting State are taxable only in that State. An annuity, as the term is used in this paragraph, means a stated sum paid periodically at stated times during a specified number of years, under an obligation to make the payment in return for adequate and full consideration (other than for services rendered). An annuity received in consideration for services rendered would be treated as either deferred compensation that is taxable in accordance with Article 14 (Income from Employment) or a pension that is subject to the rules of paragraph 1.

Paragraph 4

Paragraph 4 deals with alimony and child support payments. Under paragraph 4, alimony and child support payments paid by a resident of a Contracting State to a resident of the other Contracting State are not taxable in the recipient's State of residence. In addition, such payments are not taxable in the payor's State of residence unless he is entitled to a deduction for such payments in computing taxable income in his State of residence. The term alimony is defined as periodic payments made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support.

Paragraph 5

Paragraph 5 provides that, if a resident of a Contracting State participates in a pension fund established in the other Contracting State, the State of residence will not tax the income of the pension fund with respect to that resident until a distribution is made from the pension fund. Thus, for example, if a U.S. citizen contributes to a U.S. qualified plan while working in the United States and then establishes residence in Bulgaria, paragraph 5 prevents Bulgaria from taxing currently the plan's earnings and accretions with respect to that individual. When the resident receives a distribution from the pension fund, that distribution may be subject to tax in the State of residence under paragraph 1.

Relationship to other Articles

Paragraphs 1, 3, and 4 of Article 17 are subject to the saving clause of paragraph 4 of Article 1 (General Scope). Thus, a U.S. citizen who is resident in Bulgaria, and receives a pension, annuity or alimony payment from the United States, may be subject to U.S. tax on the payment, notwithstanding the rules in paragraphs 1, 3 and 4. Paragraphs 2 and 5 are excepted from the saving clause by virtue of subparagraph 5(a) of Article 1. Thus, the United States will not tax U.S. citizens and residents on the income described in paragraph 2, even if such amounts otherwise would be subject to tax under U.S. law, and the United States will allow U.S. citizens and residents the benefits of paragraph 5.

ARTICLE 18 (GOVERNMENT SERVICE)

Paragraph 1

Paragraph 1 deals with the taxation of government compensation (other than a pension addressed in paragraph 2). Subparagraph (a) provides that remuneration paid to any individual who is rendering services to that State, political subdivision or local authority is exempt from tax by the other State. Under subparagraph (b), such payments are, however, taxable exclusively in

the other State (i.e., the host State) if the services are rendered in that other State and the individual is a resident of that State who is either a national of that State or a person who did not become resident of that State solely for purposes of rendering the services. The paragraph applies to anyone performing services for a government, whether as a government employee, an independent contractor, or an employee of an independent contractor.

Paragraph 2

Paragraph 2 deals with the taxation of pensions 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 pensions are taxable only in that State. Subparagraph (b) provides an exception under which such pensions are taxable only in the other State if the individual is a resident of, and a national of, that other State.

Pensions paid to retired civilian and military employees of a Government of either State are intended to be covered under paragraph 2. When benefits paid by a State in respect of services rendered to that State or a subdivision or authority are in the form of social security benefits, however, those payments are covered by paragraph 2 of Article 17 (Pensions, Social Security Payments, Annuities, Alimony, and Child Support). As a general matter, the result will be the same whether Article 17 or 18 applies, since social security benefits are taxable exclusively by the source country and so are government pensions. The result will differ only when the payment is made to a citizen and resident of the other Contracting State, who is not also a citizen of the paying State. In such a case, social security benefits continue to be taxable at source while government pensions become taxable only in the residence country.

Paragraph 3

Paragraph 3 provides that the remuneration described in paragraph 1 will be subject to the rules of Articles 14 (Income from Employment), 15 (Directors' Fees), 16 (Entertainers and Sportsmen) or 17 (Pensions, Social Security Payments, Annuities, Alimony, and Child Support) if the recipient of the income is employed by a business conducted by a government.

Relationship to other Articles

Under paragraph 5(b) of Article 1 (General Scope), the saving clause (paragraph 4 of Article 1) does not apply to the benefits conferred by one of the States under Article 18 if the recipient of the benefits is neither a citizen of that State, nor a person who has been admitted for permanent residence there (i.e., in the United States, a "green card" holder). Thus, a resident of a Contracting State who in the course of performing functions of a governmental nature becomes a resident of the other State (but not a permanent resident), would be entitled to the benefits of this Article. An individual who receives a pension paid by the Government of Bulgaria in respect of services rendered to the Government of Bulgaria shall be taxable on this pension only in Bulgaria unless the individual is a U.S. citizen or acquires a U.S. green card.

ARTICLE 19 (STUDENTS, TRAINEES, TEACHERS AND RESEARCHERS)

This Article provides rules for host-country taxation of visiting students, business trainees, teachers and researchers. Persons who meet the tests of the Article will be exempt from tax in the State that they are visiting with respect to designated classes of income. Paragraph 1 addresses payments received by a student or business trainee, while paragraph 2 addresses teachers and researchers temporarily present in the host country.

Paragraph 1

Subparagraph (a) addresses the situation where a student or business trainee that is a resident of a Contracting State receives designated classes of payments while present in the host State. Several conditions must be satisfied for such an individual to be entitled to the benefits of paragraph 1.

First, the student or business trainee must have been, either at the time of his arrival in the host State or immediately before, a resident of the other Contracting State.

Second, the purpose of the visit must be the full-time education (at a college, university, or other recognized educational institution of a similar nature) or full-time training of the visitor. Thus, if the visitor comes principally to work in the host State but also is a part-time student, he would not be entitled to the benefits of paragraph 1, even with respect to any payments he may receive from abroad for his maintenance or education, and regardless of whether or not he is in a degree program. Whether a student is to be considered full-time will be determined by the rules of the educational institution at which he is studying.

The host-country exemption in paragraph 1 applies to payments received by the student or business trainee for the purpose of his maintenance, education or training that arise outside the host State. A payment will be considered to arise outside the host State if the payor is located outside the host State. Thus, if an employer from one of the Contracting States sends an employee to the other Contracting State for training, the payments the trainee receives from abroad from his employer for his maintenance or training while he is present in the host State will be exempt from tax in the host State. Where appropriate, substance prevails over form in determining the identity of the payor. Thus, for example, payments made directly or indirectly by a U.S. person with whom the visitor is training, but which have been routed through a source outside the United States (*e.g.*, a foreign subsidiary), are not treated as arising outside the United States for this purpose.

Paragraph 1 also provides a limited exemption for remuneration from personal services rendered in the host State with a view to supplementing the resources available to him for such purposes to the extent of $9,000 United States dollars (or its equivalent in the currency of Bulgaria) per taxable year. The competent authorities are instructed to adjust this amount every five years, if appropriate.

In the case of a business trainee, the benefits of paragraph 1 will extend only for a period of two years from the time that the visitor first arrives in the host country for the purpose of training. If, however, a trainee remains in the host country for a third year, thus losing the benefits of paragraph 1, he would not retroactively lose the benefits of the paragraph 1 for the first two years. The term "business trainee" is defined as a person who is in the country temporarily either for the purpose of securing training that is necessary to qualify to pursue a profession or professional specialty, or as an employee of, or under contract with, a resident of the other Contracting State, for the primary purpose of acquiring technical, professional, or business experience, from someone who is not his employer or related to his employer. Thus, a business trainee might include a lawyer employed by a law firm in one Contracting State who works for one year as a *stagiare* in an unrelated law firm in the other Contracting State. However, the term would not include a manager who normally is employed by a parent company in one Contracting State who is sent to the other Contracting State to run a factory owned by a subsidiary of the parent company.

Paragraph 2

Paragraph 2 provides a limited exemption from host State taxation for certain teachers and researchers temporarily present in the host State for the purpose of teaching or carrying on research at a school, college, university or other recognized educational or research institution. The teacher or researcher must be a resident of the other Contracting State at the beginning of his visit to the host State. The income eligible for exemption is the person's remuneration received in consideration of teaching or carrying on research. The host-country exemption will extend to payments received by a teacher or researcher only for a period of two years from the time that the visitor first arrives in the host country. A teacher or researcher remaining in the host country for more than 2 years becomes subject to tax on remuneration with respect to teaching and researching, but does not retroactively lose the benefits of paragraph 2 for the first two years. Paragraph 2 does not apply to exempt income in consideration of carrying on research if the research is primarily for the private benefit of a specific person or persons rather than in the public interest.

Relationship to other Articles

The saving clause of paragraph 4 of Article 1 (General Scope) does not apply to this Article with respect to an individual who is neither a citizen of the host State nor has been admitted for permanent residence there. The saving clause, however, does apply with respect to citizens and permanent residents of the host State. Thus, for example, a U.S. citizen who is a resident of Bulgaria and who visits the United States as a full-time student at an accredited university will not be exempt from U.S. tax on remittances from abroad that otherwise constitute U.S. taxable income. A person, however, who is not a U.S. citizen, and who visits the United States as a student and remains long enough to become a resident under U.S. law, but does not become a permanent resident (i.e., does not acquire a green card), will be entitled to the full benefits of the Article.

ARTICLE 20 (OTHER INCOME)

Article 20 generally assigns taxing jurisdiction over income not dealt with in the other articles (Articles 6 through 19) of the Convention to the State of residence of the beneficial owner of the income. In order for an item of income to be "dealt with" in another article it must be the type of income described in the article and, in most cases, it must have its source in a Contracting State. For example, all royalty income that arises in a Contracting State and that is beneficially owned by a resident of the other Contracting State is "dealt with" in Article 12 (Royalties). However, profits derived in the conduct of a business are "dealt with" in Article 7 (Business Profits) whether or not they have their source in one of the Contracting States.

Examples of items of income covered by Article 20 include income from gambling, punitive (but not compensatory) damages and covenants not to compete. The Article would also apply to income from a variety of financial transactions, where such income does not arise in the course of the conduct of a trade or business. For example, income from notional principal contracts and other derivatives would fall within Article 20 if derived by persons not engaged in the trade or business of dealing in such instruments, unless such instruments were being used to hedge risks arising in a trade or business. It would also apply to securities lending fees derived by an institutional investor. Further, in most cases guarantee fees paid within an intercompany group would be covered by Article 20, unless the guarantor were engaged in the business of providing such guarantees to unrelated parties.

Article 20 also applies to items of income that are not dealt with in the other articles because of their source or some other characteristic. For example, Article 11 (Interest) addresses

only the taxation of interest arising in a Contracting State. Interest arising in a third State that is not attributable to a permanent establishment, therefore, is subject to Article 20.

Distributions from partnerships are not generally dealt with under Article 20 because partnership distributions generally do not constitute income. Under the Code, partners include in income their distributive share of partnership income annually, and partnership distributions themselves generally do not give rise to income. This would also be the case under U.S. law with respect to distributions from trusts. Trust income and distributions that, under the Code, have the character of the associated distributable net income would generally be covered by another article of the Convention. See Code section 641 et seq.

Paragraph 1

The general rule of Article 20 is contained in paragraph 1. Items of income not dealt with in other articles and beneficially owned by a resident of a Contracting State will be taxable only in the State of residence. This exclusive right of taxation applies whether or not the residence State exercises its right to tax the income covered by the Article.

The reference in this paragraph to "items of income beneficially owned by a resident of a Contracting State" rather than simply "items of income of a resident of a Contracting State," as in the OECD Model, is intended merely to make explicit the implicit understanding in other treaties that the exclusive residence taxation provided by paragraph 1 applies only when a resident of a Contracting State is the beneficial owner of the income. Thus, source taxation of income not dealt with in other articles of the Convention is not limited by paragraph 1 if it is nominally paid to a resident of the other Contracting State, but is beneficially owned by a resident of a third State. However, income received by a nominee on behalf of a resident of that other State would be entitled to benefits.

The term "beneficially owned" 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 person who beneficially owns the income for purposes of Article 20 is the person to which the income is attributable for tax purposes under the laws of the source State.

Paragraph 2

This paragraph provides an exception to the general rule of paragraph 1 for income that is attributable to a permanent establishment maintained in a Contracting State by a resident of the other Contracting State. The taxation of such income is governed by the provisions of Article 7 (Business Profits). Therefore, income arising outside the United States that is attributable to a permanent establishment maintained in the United States by a resident of Bulgaria generally would be taxable by the United States under the provisions of Article 7. This would be true even if the income is sourced in a third State.

Relationship to Other Articles

This Article is subject to the saving clause of paragraph 4 of Article 1 (General Scope). Thus, the United States may tax the income of a resident of Bulgaria that is not dealt with elsewhere in the Convention, if that resident is a citizen of the United States. The Article is also subject to the provisions of Article 21 (Limitation on Benefits). Thus, if a resident of Bulgaria earns income that falls within the scope of paragraph 1 of Article 20, but that is taxable by the United States under U.S. law, the income would be exempt from U.S. tax under the provisions of Article 20 only if the resident satisfies one of the tests of Article 21 for entitlement to benefits.

ARTICLE 21 (LIMITATION ON BENEFITS)

Article 21 contains anti-treaty-shopping provisions that are intended to prevent residents of third countries from benefiting from what is intended to be a reciprocal agreement between two countries. In general, the provision does not rely on a determination of purpose or intention but instead sets forth a series of objective tests. A resident of a Contracting State that satisfies one of the tests will receive benefits regardless of its motivations in choosing its particular business structure.

The structure of the Article is as follows: Paragraph 1 states the general rule that residents are entitled to benefits otherwise accorded to residents only to the extent provided in the Article. Paragraph 2 lists a series of attributes of a resident of a Contracting State, the presence of any one of which will entitle that person to all the benefits of the Convention. Paragraph 3 provides a so-called "derivative benefits" test under which certain categories of income may qualify for benefits. Paragraph 4 provides that, regardless of whether a person qualifies for benefits under paragraph 2 or 3, benefits may be granted to that person with regard to certain income earned in the conduct of an active trade or business. Paragraph 5 provides special rules for so-called "triangular cases" notwithstanding paragraphs 1 through 4 of Article 21. Paragraph 6 provides that benefits also may be granted if the competent authority of the State from which benefits are claimed determines that it is appropriate to provide benefits in that case. Paragraph 7 defines certain terms used in the Article.

Paragraph 1

Paragraph 1 provides that a resident of a Contracting State will be entitled to the benefits otherwise accorded to residents of a Contracting State under the Convention only to the extent provided in the Article. The benefits otherwise accorded to residents under the Convention include all limitations on source-based taxation under Articles 6 through 20, the treaty-based relief from double taxation provided by Article 22 (Relief from Double Taxation), and the protection against discrimination afforded to residents of a Contracting State under Article 23 (Non-Discrimination). Some provisions do not require that a person be a resident in order to enjoy the benefits of those provisions. Article 24 (Mutual Agreement Procedure) is not limited to residents of the Contracting States, and Article 26 applies to diplomatic agents or consular officials regardless of residence. Article 21 accordingly does not limit the availability of treaty benefits under these provisions.

Article 21 and the anti-abuse provisions of domestic law complement each other, as Article 21 effectively 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 (*e.g.*, business purpose, substance-over-form, step transaction or conduit principles) determine whether a particular transaction should be recast in accordance with its substance. Thus, internal law principles of the source Contracting State may be applied to identify the beneficial owner of an item of income, and Article 21 then will be applied to the beneficial owner to determine if that person is entitled to the benefits of the Convention with respect to such income.

Paragraph 2

Paragraph 2 has five subparagraphs, each of which describes a category of residents that are entitled to all benefits of the Convention.

It is intended that the provisions of paragraph 2 will be self executing. Unlike the provisions of paragraph 6, discussed below, claiming benefits under paragraph 2 does not require

an 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.

Individuals -- Subparagraph 2(a)

Subparagraph (a) provides that individual residents of a Contracting State will be entitled to all treaty benefits. If such an individual receives income as a nominee on behalf of a third country resident, benefits may 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.

Governments -- Subparagraph 2(b)

Subparagraph (b) provides that the Contracting States and any political subdivision or local authority thereof will be entitled to all benefits of the Convention.

Publicly-Traded Corporations -- Subparagraph 2(c)(i)

Subparagraph (c) applies to two categories of companies: publicly traded companies and subsidiaries of publicly traded companies. A company resident in a Contracting State is entitled to all the benefits of the Convention under clause (i) of subparagraph (c) if the principal class of its shares, and any disproportionate class of shares, is regularly traded on one or more recognized stock exchanges and the company satisfies at least one of the following additional requirements: first, the company's principal class of shares is primarily traded on one or more recognized stock exchanges located in the Contracting State of which the company is a resident; or, second, the company's primary place of management and control is in its State of residence.

The term "recognized stock exchange" is defined in subparagraph 7(a). It includes (i) the NASDAQ System 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; (ii) the Bulgarian Stock Exchange – Sofia, and any other stock exchange licensed to trade securities and financial instruments under the Bulgarian law; and (iii) any other stock exchange agreed upon by the competent authorities of the Contracting States.

If a company has only one class of shares, it is only necessary to consider whether the shares of that class meet the relevant trading requirements. If the company has more than one class of shares, it is necessary as an initial matter to determine which class or classes constitute the "principal class of shares". The term "principal class of shares" is defined in subparagraph 7(b) to mean the ordinary or common shares of the company representing the majority of the aggregate voting power and value of the company. If the company does not have a class of ordinary or common shares representing the majority of the aggregate voting power and value of the company, then the "principal class of shares" is that class or any combination of classes of shares that represents, in the aggregate, a majority of the voting power and value of the company. Although in a particular case involving a company with several classes of shares it is conceivable that more than one group of classes could be identified that account for more than 50% of the shares, it is only necessary for one such group to satisfy the requirements of this subparagraph in order for the company to be entitled to benefits. Benefits would not be denied to the company even if a second, non-qualifying, group of shares with more than half of the company's voting power and value could be identified.

A company whose principal class of shares is regularly traded on a recognized stock exchange will nevertheless not qualify for benefits under subparagraph 2(c) if it has a disproportionate class of shares that is not regularly traded on a recognized stock exchange. The term "disproportionate class of shares" is defined in subparagraph 7(c). A company has a

disproportionate class of shares if it has outstanding a class of shares that is subject to terms or other arrangements that entitle the holder to a larger portion of the company's income, profit, or gain in the other Contracting State than that to which the holder would be entitled in the absence of such terms or arrangements. Thus, for example, a company resident in Bulgaria has a disproportionate class of shares if it has outstanding a class of "tracking stock" that pays dividends based upon a formula that approximates the company's return on its assets employed in the United States.

The following example illustrates this result.

Example. BulCo is a corporation resident in Bulgaria. BulCo has two classes of shares: Common and Preferred. The Common shares are listed and regularly traded on the principal stock exchange of Bulgaria. The Preferred shares have no voting rights and are entitled to receive dividends equal in amount to interest payments that BulCo receives from unrelated borrowers in the United States. The Preferred shares are owned entirely by a single investor that is a resident of a country with which the United States does not have a tax treaty. The Common shares account for more than 50 percent of the value of BulCo and for 100 percent of the voting power. Because the owner of the Preferred shares is entitled to receive payments corresponding to the U.S. source interest income earned by BulCo, the Preferred shares are a disproportionate class of shares. Because the Preferred shares are not regularly traded on a recognized stock exchange, BulCo will not qualify for benefits under subparagraph 2(c).

A class of shares will be "regularly traded" on one or more recognized stock exchanges in a taxable year, under subparagraph 7(g), if the aggregate number of shares of that class traded on one or more recognized exchanges during the twelve months ending on the day before the beginning of that taxable year is at least six percent of the average number of shares outstanding in that class during that twelve-month period. The regular trading requirement can be met by trading on any recognized exchange or exchanges located in either State. Trading on one or more recognized stock exchanges may be aggregated for purposes of this requirement. Thus, a U.S. company could satisfy the regularly traded requirement through trading, in whole or in part, on a recognized stock exchange located in Bulgaria.

The term "primarily traded" is not defined in the Convention. In accordance with paragraph 2 of Article 3 (General Definitions), this term will have the meaning it has under the laws of the State concerning the taxes to which the Convention applies, generally the source State. In the case of the United States, this term is understood to have the meaning it has under Treas. Reg. section 1.884-5(d)(3), relating to the branch tax provisions of the Code. Accordingly, stock of a corporation is "primarily traded" if the number of shares in the company's principal class of shares that are traded during the taxable year on all recognized stock exchanges in the Contracting State of which the company is a resident exceeds the number of shares in the company's principal class of shares that are traded during that year on established securities markets in any other single foreign country.

A company whose principal class of shares is regularly traded on a recognized exchange but cannot meet the primarily traded test may claim treaty benefits if its primary place of management and control is in its country of residence. This test should be distinguished from the "place of effective management" test which is used in the OECD Model and by many other countries to establish residence. In some cases, the place of effective management test has been interpreted to mean the place where the board of directors meets. By contrast, the primary place of management and control test looks to where day-to-day responsibility for the management of the company (and its subsidiaries) is exercised. The company's primary place of management and control will be located in the State in which the company is a resident only if the executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company (including direct and

indirect subsidiaries) in that State than in the other State or any third state, and the staff that support the management in making those decisions are also based in that State. Thus, the test looks to the overall activities of the relevant persons to see where those activities are conducted. In most cases, it will be a necessary, but not a sufficient, condition that the headquarters of the company (that is, the place at which the CEO and other top executives normally are based) be located in the Contracting State of which the company is a resident.

To apply the test, it will be necessary to determine which persons are to be considered "executive officers and senior management employees". In most cases, it will not be necessary to look beyond the executives who are members of the Board of Directors (the "inside directors") in the case of a U.S. company. That will not always be the case, however; in fact, the relevant persons may be employees of subsidiaries if those persons make the strategic, financial and operational policy decisions. Moreover, it would be necessary to take into account any special voting arrangements that result in certain board members making certain decisions without the participation of other board members.

Subsidiaries of Publicly-Traded Corporations -- Subparagraph 2(c)(ii)

A company resident in a Contracting State is entitled to all the benefits of the Convention under clause (ii) of subparagraph 2(c) if five or fewer publicly traded companies described in clause (i) are the direct or indirect owners of at least 50 percent of the aggregate vote and value of the company's shares (and at least 50 percent of any disproportionate class of shares). If the publicly-traded companies are indirect owners, however, each of the intermediate companies must be a resident of one of the Contracting States.

Thus, for example, a company that is a resident of Bulgaria, all the shares of which are owned by another company that is a resident of Bulgaria, would qualify for benefits under the Convention if the principal class of shares (and any disproportionate classes of shares) of the parent company are regularly and primarily traded on a recognized stock exchange in Bulgaria. However, such a subsidiary would not qualify for benefits under clause (ii) if the publicly traded parent company were a resident of a third state, for example, and not a resident of the United States or Bulgaria. Furthermore, if a parent company in Bulgaria indirectly owned the bottom-tier company through a chain of subsidiaries, each such subsidiary in the chain, as an intermediate owner, must be a resident of the United States or Bulgaria in order for the subsidiary to meet the test in clause (ii).

Tax Exempt Organizations -- Subparagraph 2(d)

Subparagraph 2(d) provides rules by which the tax exempt organizations described in paragraph 2 of Article 4 (Resident) will be entitled to all the benefits of the Convention. A pension fund will qualify for benefits if more than fifty percent of the beneficiaries, members or participants of the organization are individuals resident in either Contracting State. For purposes of this provision, the term "beneficiaries" should be understood to refer to the persons receiving benefits from the organization. On the other hand, a tax-exempt organization other than a pension fund automatically qualifies for benefits, without regard to the residence of its beneficiaries or members. Entities qualifying under this rule are those that are generally exempt from tax in their State of residence and that are organized and operated exclusively to fulfill religious, charitable, scientific, artistic, cultural, or educational purposes.

Ownership Base Erosion -- Subparagraph 2(e)

Subparagraph 2(e) provides an additional method to qualify for treaty benefits that applies to any form of legal entity that is a resident of a Contracting State. The test provided in subparagraph (e), the so-called ownership and base erosion test, is a two-part test. Both prongs of the test must be satisfied for the resident to be entitled to treaty benefits under subparagraph 2(e).

The ownership prong of the test, under clause (i), requires that at least 50 percent of the aggregate voting power and value (and at least 50 percent of any disproportionate class of shares) of shares or other beneficial interests in the person is owned, directly or indirectly, on at least half the days of the person's taxable year by persons who are residents of the Contracting State of which that person is a resident and that are themselves entitled to treaty benefits under subparagraphs 2(a), (b), (c)(i), or (d). In the case of indirect owners, each of the intermediate owners must be a resident of that Contracting State.

Trusts may be entitled to benefits under this provision if they are treated as residents under Article 4 (Resident) and they otherwise satisfy the requirements of this subparagraph. For purposes of this subparagraph, the beneficial interests in a trust will be considered to be owned by its beneficiaries in proportion to each beneficiary's actuarial interest in the trust. The interest of a remainder beneficiary will be equal to 100 percent less the aggregate percentages held by income beneficiaries. A beneficiary's interest in a trust will not be considered to be owned by a person entitled to benefits under the other provisions of paragraph 2 if it is not possible to determine the beneficiary's actuarial interest. Consequently, if it is not possible to determine the actuarial interest of the beneficiaries in a trust, the ownership test under clause i) cannot be satisfied, unless all possible beneficiaries are persons entitled to benefits under subparagraphs 2(a), (b), (c)(i), or (d).

The base erosion prong of clause (ii) of subparagraph (e) is satisfied with respect to a person if less than 50 percent of the person's gross income for the taxable year, as determined under the tax law in the person's State of residence, is paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State entitled to benefits under subparagraphs (a), (b), (c)(i), or (d), in the form of payments deductible for tax purposes in the payor's State of residence. These amounts do not include arm's-length payments in the ordinary course of business for services or tangible property. To the extent they are deductible from the taxable base, trust distributions are deductible payments. However, depreciation and amortization deductions, which do not represent payments or accruals to other persons, are disregarded for this purpose.

Paragraph 3

Paragraph 3 sets forth a derivative benefits test that is potentially applicable to all treaty benefits, although the test is applied to individual items of income. In general, a derivative benefits test entitles the resident of a Contracting State to treaty benefits if the owner of the resident would have been entitled to the same benefit had the income in question flowed directly to that owner. To qualify under this paragraph, the company must meet an ownership test and a base erosion test.

Subparagraph (a) sets forth the ownership test. Under this test, seven or fewer equivalent beneficiaries must own shares representing at least 95 percent of the aggregate voting power and value of the company and at least 50 percent of any disproportionate class of shares. Ownership may be direct or indirect. The term "equivalent beneficiary" is defined in subparagraph (e) of

paragraph 7. This definition may be met in two alternative ways, the first of which has two requirements.

Under the first alternative, a person may be an equivalent beneficiary because it is entitled to equivalent benefits under a treaty between the country of source and the country in which the person is a resident. This alternative has two requirements.

The first requirement is that the person must be a resident of a member state of the European Union, or of a European Economic Area state, or of a party to the North American Free Trade Agreement (collectively, "qualifying States").

The second requirement of the definition of "equivalent beneficiary" is that the person must be entitled to equivalent benefits under an applicable treaty. To satisfy the second requirement, the person must be entitled to all the benefits of a comprehensive treaty between the Contracting State from which benefits of the Convention are claimed and a qualifying State under provisions that are analogous to the rules in paragraph 2 (a), (b), (c)(i), and (d) of this Article. If the treaty in question does not have a comprehensive limitation on benefits article, this requirement is met only if the person would be entitled to treaty benefits under the tests in subparagraphs 2(a), (b), (c)(i), and (d) of this Article if the person were a resident of one of the Contracting States.

In order to satisfy the second requirement necessary to qualify as an "equivalent beneficiary" under subparagraph 7(e)(i)(B) with respect to dividends, interest, royalties or branch tax, the person must be entitled to a rate of tax that is at least as low as the tax rate that would apply under the Convention to such income. Thus, the rates to be compared are: (1) the rate of tax that the source State would have imposed if a qualified resident of the other Contracting State was the beneficial owner of the income; and (2) the rate of tax that the source State would have imposed if the third State resident received the income directly from the source State.

Subparagraph 7(f) provides a special rule to take account of the fact that withholding taxes on many inter-company dividends, interest and royalties are exempt within the European Union by reason of various EU directives, rather than by tax treaty. If a U.S. company receives such payments from a Bulgarian company, and that U.S. company is owned by a company resident in a member state of the European Union that would have qualified for an exemption from withholding tax if it had received the income directly, the parent company will be treated as an equivalent beneficiary. This rule is necessary because many European Union member countries have not re-negotiated their tax treaties to reflect the exemptions available under the directives.

The requirement that a person be entitled to "all the benefits" of a comprehensive tax treaty eliminates those persons that qualify for benefits with respect to only certain types of income. Accordingly, the fact that a French parent of a Bulgarian company is engaged in the active conduct of a trade or business in France and therefore would be entitled to the benefits of the U.S.-France treaty if it received dividends directly from a U.S. subsidiary of the Bulgarian company is not sufficient for purposes of this paragraph. Further, the French company cannot be an equivalent beneficiary if it qualifies for benefits only with respect to certain income as a result of a "derivative benefits" provision in the U.S.-France treaty. However, it would be possible to look through the French company to its parent company to determine whether the parent company is an equivalent beneficiary.

The second alternative for satisfying the "equivalent beneficiary" test is available only to residents of one of the two Contracting States. U.S. or Bulgarian residents who are eligible for treaty benefits by reason of subparagraphs 2(a), (b), (c)(i), or (d) are equivalent beneficiaries for purposes of the relevant tests in Article 21. Thus, a Bulgarian individual will be an equivalent beneficiary without regard to whether the individual would have been entitled to receive the same benefits if it received the income directly. A resident of a third country cannot qualify for treaty benefits under these provisions by reason of those paragraphs or any other rule of the treaty, and therefore does not qualify as an equivalent beneficiary under this alternative. Thus, a resident of a third country can be an equivalent beneficiary only if it would have been entitled to equivalent benefits had it received the income directly.

The second alternative was included in order to clarify that ownership by certain residents of a Contracting State would not disqualify a U.S. or Bulgarian company under this paragraph. Thus, for example, if 90 percent of a Bulgarian company is owned by five companies that are resident in member states of the European Union who satisfy the requirements of subparagraph7(e)(i), and 10 percent of the Bulgarian company is owned by a U.S. or Bulgarian individual, then the Bulgarian company still can satisfy the requirements of subparagraph 3(a).

Subparagraph 3(b) sets forth the base erosion test. A company meets this base erosion test if less than 50 percent of its gross income (as determined in the company's State of residence) for the taxable period is paid or accrued, directly or indirectly, to a person or persons who are not equivalent beneficiaries in the form of payments deductible for tax purposes in company's State of residence. These amounts do not include arm's-length payments in the ordinary course of business for services or tangible property. This test is the same as the base erosion test in subparagraph 2(e)(ii), except that the test in paragraph 3(b) focuses on base-eroding payments to persons who are not equivalent beneficiaries.

Paragraph 4

Paragraph 4 sets forth an alternative test under which a resident of a Contracting State may receive treaty benefits with respect to certain items of income that are connected to an active trade or business conducted in its State of residence. A resident of a Contracting State may qualify for benefits under paragraph 4 whether or not it also qualifies under paragraph 2 or 3.

Subparagraph (a) sets forth the general rule that a resident of a Contracting State engaged in the active conduct of a trade or business in that State may obtain the benefits of the Convention with respect to an item of income derived in the other Contracting State. The item of income, however, must be derived in connection with or incidental to that trade or business.

The term "trade or business" is not defined in the Convention. Pursuant to paragraph 2 of Article 3 (General Definitions), when determining whether a resident of Bulgaria is entitled to the benefits of the Convention under paragraph 4 of this Article with respect to an item of income derived from sources within the United States, the United States will ascribe to this term the meaning that it has under the law of the United States. Accordingly, the U.S. competent authority will refer to the regulations issued under section 367(a) for the definition of the term "trade or business." In general, therefore, a trade or business will be considered to be a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit. Furthermore, a corporation generally will be considered to carry on a trade or business only if the officers and employees of the corporation conduct substantial managerial and operational activities.

The business of making or managing investments for the resident's own account will be considered to be a trade or business only when part of banking, insurance or securities activities conducted by a bank, an insurance company, or a registered securities dealer. Such activities conducted by a person other than a bank, insurance company or registered securities dealer will not be considered to be the conduct of an active trade or business, nor would they be considered to be the conduct of an active trade or business if conducted by a bank, insurance company or registered securities dealer but not as part of the company's banking, insurance or dealer business. Because a headquarters operation is in the business of managing investments, a company that functions solely as a headquarters company will not be considered to be engaged in an active trade or business for purposes of paragraph 4.

An item of income is derived in connection with a trade or business if the income-producing activity in the State of source is a line of business that "forms a part of" or is "complementary" to the trade or business conducted in the State of residence by the income recipient.

A business activity generally will be considered to form part of a business activity conducted in the State of source if the two activities involve the design, manufacture or sale of the same products or type of products, or the provision of similar services. The line of business in the State of residence may be upstream, downstream, or parallel to the activity conducted in the State of source. Thus, the line of business may provide inputs for a manufacturing process that occurs in the State of source, may sell the output of that manufacturing process, or simply may sell the same sorts of products that are being sold by the trade or business carried on in the State of source.

Example 1. USCo is a corporation resident in the United States. USCo is engaged in an active manufacturing business in the United States. USCo owns 100 percent of the shares of BulCo, a corporation resident in Bulgaria. BulCo distributes USCo products in Bulgaria. Since the business activities conducted by the two corporations involve the same products, BulCo's distribution business is considered to form a part of USCo's manufacturing business.

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

For two activities to be considered to be "complementary," the activities need not relate to the same types of products or services, but they should be part of the same overall industry and be related in the sense that the success or failure of one activity will tend to result in success or failure for the other. Where more than one trade or business is conducted in the State of source and only one of the trades or businesses forms a part of or is complementary to a trade or business conducted in the State of residence, it is necessary to identify the trade or business to which an item of income is attributable. Royalties generally will be considered to be derived in connection with the trade or business to which the underlying intangible property is attributable. Dividends will be deemed to be derived first out of earnings and profits of the treaty-benefited trade or business, and then out of other earnings and profits. Interest income may be allocated under any reasonable method consistently applied. A method that conforms to U.S. principles for expense allocation will be considered a reasonable method.

Example 3. Americair is a corporation resident in the United States that operates an international airline. BulSub is a wholly-owned subsidiary of Americair resident in Bulgaria. BulSub operates a chain of hotels in Bulgaria that are located near airports served by Americair

flights. Americair frequently sells tour packages that include air travel to Bulgaria and lodging at BulSub hotels. Although both companies are engaged in the active conduct of a trade or business, the businesses of operating a chain of hotels and operating an airline are distinct trades or businesses. Therefore BulSub's business does not form a part of Americair's business. However, BulSub's business is considered to be complementary to Americair's business because they are part of the same overall industry (travel) and the links between their operations tend to make them interdependent.

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

Example 5. USFlower is a corporation resident in the United States. USFlower produces and sells flowers in the United States and other countries. USFlower owns all the shares of BulHolding, a corporation resident in Bulgaria. BulHolding is a holding company that is not engaged in a trade or business. BulHolding owns all the shares of three corporations that are resident in Bulgaria: BulFlower, BulLawn, and BulFish. BulFlower distributes USFlower flowers under the USFlower trademark in Bulgaria. BulLawn markets a line of lawn care products in Bulgaria under the USFlower trademark. In addition to being sold under the same trademark, BulLawn and BulFlower products are sold in the same stores and sales of each company's products tend to generate increased sales of the other's products. BulFish imports fish from the United States and distributes it to fish wholesalers in Bulgaria. For purposes of paragraph 4, the business of BulFlower forms a part of the business of USFlower, the business of BulLawn is complementary to the business of USFlower, and the business of BulFish is neither part of nor complementary to that of USFlower.

An item of income derived from the State of source is "incidental to" the trade or business carried on in the State of residence if production of the item facilitates the conduct of the trade or business in the State of residence. An example of incidental income is the temporary investment of working capital of a person in the State of residence in securities issued by persons in the State of source.

Subparagraph 4(b) states a further condition to the general rule in subparagraph (a) in cases where the trade or business generating the item of income in question is carried on either by the person deriving the income or by any associated enterprises. Subparagraph (b) states that the trade or business carried on in the State of residence, under these circumstances, must be substantial in relation to the activity in the State of source. The substantiality requirement is intended to prevent a narrow case of treaty-shopping abuses in which a company attempts to qualify for benefits by engaging in de minimis connected business activities in the treaty country in which it is resident (*i.e.*, activities that have little economic cost or effect with respect to the company business as a whole).

The determination of substantiality is made based upon all the facts and circumstances and takes into account the comparative sizes of the trades or businesses in each Contracting State, the nature of the activities performed in each Contracting State, and the relative contributions made to that trade or business in each Contracting State.

The determination in subparagraph (b) also is made separately for each item of income derived from the State of source. It therefore is possible that a person would be entitled to the benefits of the Convention with respect to one item of income but not with respect to another. If a resident of a Contracting State is entitled to treaty benefits with respect to a particular item of

income under paragraph 4, the resident is entitled to all benefits of the Convention insofar as they affect the taxation of that item of income in the State of source.

The application of the substantiality requirement only to income from related parties focuses only on potential abuse cases, and does not hamper certain other kinds of non-abusive activities, even though the income recipient resident in a Contracting State may be very small in relation to the entity generating income in the other Contracting State. For example, if a small U.S. research firm develops a process that it licenses to a very large, unrelated, pharmaceutical manufacturer in Bulgaria, the size of the U.S. research firm would not have to be tested against the size of the manufacturer. Similarly, a small U.S. bank that makes a loan to a very large unrelated company operating a business in Bulgaria would not have to pass a substantiality test to receive treaty benefits under paragraph 4.

Subparagraph 4(c) provides special attribution rules for purposes of applying the substantive rules of subparagraphs (a) and (b). These rules apply for purposes of determining whether a person meets the requirement in subparagraph (a) that it be engaged in the active conduct of a trade or business and that the item of income is derived in connection with that active trade or business, and for making the comparison required by the "substantiality" requirement in subparagraph (b). Subparagraph (c) attributes to a person activities conducted by persons "connected" to such person. A person ("X") is connected to another person ("Y") if X possesses 50 percent or more of the beneficial interest in Y (or if Y possesses 50 percent or more of the beneficial interest in X). For this purpose, X is connected to a company if X owns shares representing fifty percent or more of the aggregate voting power and value of the company or fifty percent or more of the beneficial equity interest in the company. X also is connected to Y if a third person possesses, directly or indirectly, fifty percent or more of the beneficial interest in both X and Y. For this purpose, if X or Y is a company, the threshold relationship with respect to such company or companies is fifty percent or more of the aggregate voting power and value or fifty percent or more of the beneficial equity interest. Finally, X is connected to Y if, based upon all the facts and circumstances, X controls Y, Y controls X, or X and Y are controlled by the same person or persons.

Paragraph 5

Paragraph 5 deals with the treatment of interest or royalty income in the context of a so-called "triangular case." The paragraph provides special rules applicable to U.S. source interest or royalties that are attributable to a permanent establishment that a Bulgarian company has in a third state, and that are otherwise exempt from taxation in Bulgaria.

The term "triangular case" refers to the use of the following structure by a resident of Bulgaria to earn, in this case, interest income from the United States. The resident of Bulgaria, who is assumed to qualify for benefits under one or more of the provisions of Article 21 (Limitation on Benefits), sets up a permanent establishment in a third jurisdiction that imposes only a low rate of tax on the income of the permanent establishment. The Bulgarian resident lends funds into the United States through the permanent establishment. The permanent establishment, despite its third-jurisdiction location, is an integral part of a Bulgarian resident. Therefore, the income earned on those loans, absent the provisions of paragraph 5, may be entitled to a reduced rate of U.S. withholding tax under the Convention. Under a current Bulgarian income tax treaty with the host jurisdiction of the permanent establishment, the income of the permanent establishment is exempt from Bulgarian tax. Alternatively, Bulgaria may choose to exempt the income of the permanent establishment from Bulgarian income tax. Thus, the interest income is subject to a reduced rate of U.S. tax, is subject to little tax in the host jurisdiction of the permanent establishment, and is exempt from Bulgarian tax.

Because the United States does not exempt the profits of a third-jurisdiction permanent establishment of a U.S. resident from U.S. tax, either by statute or by treaty, the paragraph only applies with respect to U.S. source interest or royalties that are attributable to a third-jurisdiction permanent establishment of a Bulgarian resident.

Paragraph 5 replaces the otherwise applicable rules in the Convention for interest and royalties with a 15 percent withholding tax for interest and royalties if the actual tax paid on the income in the third state is less than 60 percent of the tax that would have been payable in Bulgaria if the income were earned in Bulgaria by the enterprise and were not attributable to the permanent establishment in the third state.

In general, the principles employed under Code section 954(b)(4) will be employed to determine whether the profits are subject to an effective rate of taxation that is above the specified threshold.

Notwithstanding the level of tax on interest and royalty income of the permanent establishment, paragraph 5 will not apply under certain circumstances. In the case of interest (as defined in Article 11 (Interest)), paragraph 5 will not apply if the interest is derived in connection with, or is incidental to, the active conduct of a trade or business carried on by the permanent establishment in the third state. The business of making, managing or simply holding investments is not considered to be an active trade or business, unless these are banking or securities activities carried on by a bank or registered securities dealer. In the case of royalties (as defined in Article 12 (Royalties)), paragraph 5 will not apply if the royalties are received as compensation for the use of, or the right to use, intangible property produced or developed by the permanent establishment itself.

Paragraph 6

Paragraph 6 provides that a resident of one of the States that is not entitled to the benefits of the Convention as a result of paragraphs 2 through 4 still may be granted benefits under the Convention at the discretion of the competent authority of the State from which benefits are claimed. Under paragraph 6, that competent authority will determine whether the establishment, acquisition, or maintenance of the person seeking benefits under the Convention, or the conduct of such person's operations, has or had as one of its principal purposes the obtaining of benefits under the Convention. Benefits will not be granted, however, solely because a company was established prior to the effective date of a treaty or protocol. In that case a company would still be required to establish to the satisfaction of the Competent Authority clear non-tax business reasons for its formation in a Contracting State, or that the allowance of benefits would not otherwise be contrary to the purposes of the treaty. Thus, persons that establish operations in one of the States with a principal purpose of obtaining the benefits of the Convention ordinarily will not be granted relief under paragraph 6.

The competent authority's discretion is quite broad. It may grant all of the benefits of the Convention to the taxpayer making the request, or it may grant only certain benefits. For instance, it may grant benefits only with respect to a particular item of income in a manner similar to paragraph 4. Further, the competent authority may establish conditions, such as setting time limits on the duration of any relief granted.

For purposes of implementing paragraph 6, a taxpayer will be permitted to present his case to the relevant competent authority for an advance determination based on the facts. In these circumstances, it is also expected that, if the competent authority determines that benefits are to be allowed, they will be allowed retroactively to the time of entry into force of the relevant treaty provision or the establishment of the structure in question, whichever is later.

Finally, there may be cases in which a resident of a Contracting State may apply for discretionary relief to the competent authority of his State of residence. This would arise, for example, if the benefit the resident is claiming is provided by the residence country, and not by the source country. So, for example, if a company that is a resident of the United States would like to claim the benefit of the re-sourcing rule of paragraph 3 of Article 22, but it does not meet any of the objective tests of this Article, it may apply to the U.S. competent authority for discretionary relief.

Paragraph 7

Paragraph 7 defines several key terms for purposes of Article 21. Each of the defined terms is discussed above in the context in which it is used.

ARTICLE 22 (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 under its internal law, and by treaty.

Paragraph 1

Paragraph 1 provides that Bulgaria will provide relief from double taxation through a mixture of the credit and exemption methods.

Subparagraph 1(a) states the general rule that Bulgaria will exempt income derived by a resident if the income may be taxed in the United States in accordance with the Convention. Subparagraph 1(c), permits Bulgaria to include the income corresponding to the U.S. tax in the resident's tax base in calculating the Bulgarian tax on the remaining income of the resident. This rule provides for "exemption with progression." Under subparagraph 1(b), Bulgaria provides for a tax credit rather than an exemption with respect to limited classes of income. If the income may be taxed by the United States under the provisions of Article 10 (Dividends), Article 11 (Interest), or Article 12 (Royalties), Bulgaria will relieve double taxation by allowing a credit against Bulgarian tax in an amount equal to the tax paid in the United States on such income, but limited to the amount of Bulgarian tax attributable to such dividends, interest, and royalty income.

Paragraph 2

The United States agrees, in paragraph 2, to allow to its citizens and residents a credit against U.S. tax for income taxes paid or accrued to Bulgaria. Paragraph 2 also provides that Bulgaria's covered taxes are income taxes for U.S. purposes. This provision is based on the Treasury Department's review of Bulgaria's laws.

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

The credits allowed under paragraph 2 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 the Article, that is, the allowance of a credit, is retained. Thus, although the Convention provides for a foreign tax credit, the terms of the credit are determined by the provisions, at the time a credit is given, of the U.S. statutory credit.

Therefore, the U.S. credit under the Convention is subject to the various limitations of U.S. law (see, *e.g.*, Code sections 901-908). For example, the credit against U.S. tax generally is limited 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) and (d)), and the dollar amount of the credit is determined in accordance with U.S. currency translation rules (see, *e.g.*, Code section 986). Similarly, U.S. law applies to determine carryover periods for excess credits and other inter-year adjustments.

Paragraph 3

Paragraph 3 provides a re-sourcing rule for gross income covered by paragraph 2. Paragraph 3 is intended to ensure that a U.S. resident can obtain an appropriate amount of U.S. foreign tax credit for income taxes paid to Bulgaria when the Convention assigns to Bulgaria primary taxing rights over an item of gross income.

Accordingly, if the Convention allows Bulgaria to tax an item of gross income (as defined under U.S. law) derived by a resident of the United States, the United States will treat that item of gross income as gross income from sources within Bulgaria for U.S. foreign tax credit purposes. In the case of a U.S.-owned foreign corporation, however, section 904(h)(10) may apply for purposes of determining the U.S. foreign tax credit with respect to income subject to this re-sourcing rule. Section 904(h)(10) generally applies the foreign tax credit limitation separately to re-sourced income. Furthermore, the paragraph 3 re-sourcing rule applies to gross income, not net income. Accordingly, U.S. expense allocation and apportionment rules, see, *e.g.*, Treas. Reg. section 1.861-9, continue to apply to income resourced under paragraph 3.

Paragraph 4

Paragraph 4 provides special rules for the tax treatment in both States of certain types of income derived from U.S. sources by U.S. citizens who are residents of Bulgaria. Since U.S. citizens, regardless of residence, 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 Bulgaria may exceed the U.S. tax that may be imposed under the Convention on an item of U.S. source income derived by a resident of Bulgaria who is not a U.S. citizen. The provisions of paragraph 4 ensure that Bulgaria does not bear the cost of U.S. taxation of its citizens who are residents of Bulgaria.

Subparagraph (a) provides, with respect to items of income from sources within the United States, special credit rules for Bulgaria. These rules apply to items of U.S.-source income that would be either exempt from U.S. tax or subject to reduced rates of U.S. tax under the provisions of the Convention if they had been received by a resident of Bulgaria who is not a U.S. citizen. The tax credit allowed by Bulgaria under paragraph 4 with respect to such items need not exceed the U.S. tax that may be imposed under the Convention, other than tax imposed solely by reason of the U.S. citizenship of the taxpayer under the provisions of the saving clause of paragraph 4 of Article 1 (General Scope).

For example, if a U.S. citizen resident in Bulgaria receives portfolio dividends from sources within the United States, the foreign tax credit granted by Bulgaria would be limited to 10 percent of the dividend – the U.S. tax that may be imposed under subparagraph 2(b) of Article 10 (Dividends) – even if the shareholder is subject to U.S. net income tax because of his U.S. citizenship.

Subparagraph 4(b) eliminates the potential for double taxation that can arise because subparagraph 4(a) provides that Bulgaria need not provide full relief for the U.S. tax imposed on its citizens resident in Bulgaria. The subparagraph provides that the United States will credit the

income tax paid or accrued to Bulgaria, after the application of subparagraph 4(a). It further provides that in allowing the credit, the United States will not reduce its tax below the amount that is taken into account in Bulgaria in applying subparagraph 4(a).

Since the income described in paragraph 4(a) generally will be U.S. source income, special rules are required to re-source some of the income to Bulgaria in order for the United States to be able to credit the tax paid to Bulgaria. This re-sourcing is provided for in subparagraph 4(c), which deems the items of income referred to in subparagraph 4(a) to be from foreign sources to the extent necessary to avoid double taxation under subparagraph 4(b). Subparagraph 3(e) of Article 24 (Mutual Agreement Procedure) provides a mechanism by which the competent authorities can resolve any disputes regarding whether income is from sources within the United States.

The following two examples illustrate the application of paragraph 4 in the case of a U.S.-source portfolio dividend received by a U.S. citizen resident in Bulgaria. In both examples, the U.S. rate of tax on residents of Bulgaria, under subparagraph 2(b) of Article 10 (Dividends) of the Convention, is 10 percent. In both examples, the U.S. income tax rate on the U.S. citizen is 35 percent. In example 1, the rate of income tax imposed in Bulgaria on its resident (the U.S. citizen) is 25 percent (below the U.S. rate), and in example 2, the rate imposed on its resident is 40 percent (above the U.S. rate).

	Example 1	Example 2
Subparagraph (a)		
U.S. dividend declared	$100.00	$100.00
Notional U.S. withholding tax (Article 10(2)(b))	10.00	10.00
Taxable income in Bulgaria	100.00	100.00
Bulgaria tax before credit	25.00	40.00
Less: tax credit for notional U.S. withholding tax	10.00	10.00
Net post-credit tax paid to Bulgaria	15.00	30.00
Subparagraphs (b) and (c)		
U.S. pre-tax income	$100.00	$100.00
U.S. pre-credit citizenship tax	35.00	35.00
Notional U.S. withholding tax	10.00	10.00
U.S. tax eligible to be offset by credit	25.00	25.00
Tax paid to Bulgaria	15.00	30.00
Income re-sourced from U.S. to foreign source (see below)	42.86	71.43
U.S. pre-credit tax on re-sourced income	15.00	25.00
U.S. credit for tax paid to Bulgaria	15.00	25.00
Net post-credit U.S. tax	10.00	0.00
Total U.S. tax	20.00	10.00

In both examples, in the application of subparagraph (a), Bulgaria credits a 10 percent U.S. tax against its residence tax on the U.S. citizen. In the first example, the net tax paid to Bulgaria after the foreign tax credit is $15.00; in the second example, it is $30.00. In the application of subparagraphs (b) and (c), from the U.S. tax due before credit of $35.00, the United States subtracts the amount of the U.S. source tax of $10.00, against which no U.S. foreign tax credit is allowed. This subtraction ensures that the United States collects the tax that it is due under the Convention as the State of source.

In both examples, given the 35 percent U.S. tax rate, the maximum amount of U.S. tax against which credit for the tax paid to Bulgaria may be claimed is $25 ($35 U.S. tax minus $10

U.S. withholding tax). Initially, all of the income in both examples was from sources within the United States. For a U.S. foreign tax credit to be allowed for the full amount of the tax paid to Bulgaria, an appropriate amount of the income must be re-sourced to Bulgaria under subparagraph (c).

The amount that must be re-sourced depends on the amount of tax for which the U.S. citizen is claiming a U.S. foreign tax credit. In example 1, the tax paid to Bulgaria was $15. For this amount to be creditable against U.S. tax, $42.86 ($15 tax divided by 35 percent U.S. tax rate) must be resourced to Bulgaria. There is a net U.S. tax of $10 due after credit ($25 U.S. tax eligible to be offset by credit, minus $15 tax paid to Bulgaria). Thus, in example 1, there is a total of $20 in U.S. tax ($10 U.S. withholding tax plus $10 residual U.S. tax).

In example 2, the tax paid to Bulgaria was $30, but, because the United States subtracts the U.S. withholding tax of $10 from the total U.S. tax of $35, only $25 of U.S. taxes may be offset by taxes paid to Bulgaria. Accordingly, the amount that must be resourced to Bulgaria is limited to the amount necessary to ensure a U.S. foreign tax credit for $25 of tax paid to Bulgaria, or $71.43 ($25 tax paid to Bulgaria divided by 35 percent U.S. tax rate). When the tax paid to Bulgaria is credited against the U.S. tax on this re-sourced income, there is no residual U.S. tax ($25 U.S. tax minus $30 tax paid to Bulgaria, subject to the U.S. limit of $25). Thus, in example 2, there is a total of $10 in U.S. tax ($10 U.S. withholding tax plus $0 residual U.S. tax). Because the tax paid to Bulgaria was $30 and the U.S. tax eligible to be offset by credit was $25, there is $5 of excess foreign tax credit available for carryover.

Relationship to other Articles

By virtue of subparagraph 5(a) of Article 1 (General Scope), Article 22 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 (such as the re-sourcing provided by paragraph 3 and subparagraph 4(c)).

ARTICLE 23 (NON-DISCRIMINATION)

This Article ensures that nationals of a Contracting State, in the case of paragraph 1, and residents of a Contracting State, in the case of paragraphs 2 through 5, will not be subject, directly or indirectly, to discriminatory taxation in the other Contracting State. Not all differences in tax treatment, either as between nationals of the two States, or between residents of the two States, are violations of the prohibition against discrimination. Rather, the non-discrimination obligations of this Article apply only if the nationals or residents of the two States are comparably situated.

Each of the relevant paragraphs of the Article provides that two persons that are comparably situated must be treated similarly. Although the actual words differ from paragraph to paragraph (*e.g.*, paragraph 1 refers to two nationals "in the same circumstances," paragraph 2 refers to two enterprises "carrying on the same activities" and paragraph 4 refers to two enterprises that are "similar"), the common underlying premise is that if the difference in treatment is directly related to a tax-relevant difference in the situations of the domestic and foreign persons being compared, that difference is not to be treated as discriminatory (i.e., if one person is taxable in a Contracting State on worldwide income and the other is not, or tax may be collectible from one person at a later stage, but not from the other, distinctions in treatment would be justified under paragraph 1). Other examples of such factors that can lead to non-discriminatory differences in treatment are noted in the discussions of each paragraph.

The operative paragraphs of the Article also use different language to identify the kinds of differences in taxation treatment that will be considered discriminatory. For example, paragraphs 1 and 4 speak of "any taxation or any requirement connected therewith that is more burdensome," while paragraph 2 specifies that a tax "shall not be less favorably levied." Regardless of these differences in language, only differences in tax treatment that materially disadvantage the foreign person relative to the domestic person are properly the subject of the Article.

Paragraph 1

Paragraph 1 provides that a national of one Contracting State may not be subject to taxation or connected requirements in the other Contracting State that are more burdensome than the taxes and connected requirements imposed upon a national of that other State in the same circumstances. The OECD Model language would prohibit taxation that is "other than or more burdensome" than that imposed on U.S. persons. This Convention omits the reference to taxation that is "other than" that imposed on U.S. persons because the only relevant question under this provision should be whether the requirement imposed on a national of the other Contracting State is more burdensome. A requirement may be different from the requirements imposed on U.S. nationals without being more burdensome.

The term "national" in relation to a Contracting State is defined in subparagraph 1(l) of Article 3 (General Definitions). The term includes both individuals and juridical persons. 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 Bulgaria as a national of Bulgaria who is in similar circumstances (i.e., presumably one who is resident in a third State).

As noted above, whether or not the two persons are both taxable on worldwide income is a significant circumstance for this purpose. For this reason, paragraph 1 specifically states that the United States is not obligated to apply the same taxing regime to a national of Bulgaria who is not resident in the United States as it applies to a U.S. national who is not resident in the United States. 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 Bulgaria who are not United States residents. Thus, for example, Article 23 would not entitle a national of Bulgaria resident in a third country to taxation at graduated rates on U.S. source dividends or other investment income that applies to a U.S. citizen resident in the same third country.

Paragraph 2

Paragraph 2 of the Article, provides that a Contracting State may not tax a permanent establishment of an enterprise of the other Contracting State less favorably than an enterprise of that first-mentioned State that is carrying on the same activities.

The fact that a U.S. permanent establishment of an enterprise of Bulgaria is subject to U.S. tax only on income that is attributable to the permanent establishment, while a U.S. corporation engaged in the same activities is taxable on its worldwide income is not, in itself, a sufficient difference to provide different treatment for the permanent establishment. There are cases, however, where the two enterprises would not be similarly situated and differences in treatment may be warranted. For instance, it would not be a violation of the non-discrimination protection of paragraph 2 to require the foreign enterprise to provide information in a reasonable manner that may be different from the information requirements imposed on a resident enterprise, because information may not be as readily available to the Internal Revenue Service from a foreign as from a domestic enterprise. Similarly, it would not be a violation of paragraph

2 to impose penalties on persons who fail to comply with such a requirement (see, *e.g.*, sections 874(a) and 882(c)(2)). Further, a determination that income and expenses have been attributed or allocated to a permanent establishment in conformity with the principles of Article 7 (Business Profits) implies that the attribution or allocation was not discriminatory.

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 share of the partnership income of a partner resident in Bulgaria, and attributable to a U.S. permanent establishment. There is no similar obligation with respect to the distributive shares of U.S. resident partners. It is understood, however, that this distinction is not a form of discrimination within the meaning of paragraph 2 of the Article. No distinction is made between U.S. and non-U.S. partnerships, since the law requires that partnerships of both U.S. and non-U.S. domicile withhold tax in respect of the partnership shares of non-U.S. partners. Furthermore, in distinguishing between U.S. and non-U.S. partners, the requirement to withhold on the non-U.S. but not the U.S. partner's share is not discriminatory taxation, but, like other withholding on nonresident aliens, is merely a reasonable method for the collection of tax from persons who are not continually present in the United States, and as to whom it otherwise may be difficult for the United States to enforce its tax jurisdiction. If tax has been over-withheld, the partner can, as in other cases of over-withholding, file for a refund.

Paragraph 3

Paragraph 3 makes clear that the provisions of paragraphs 1 and 2 do not obligate a Contracting State to grant to a resident of the other Contracting State any tax allowances, reliefs, etc., that it grants to its own residents on account of their civil status or family responsibilities. Thus, if a sole proprietor who is a resident of Bulgaria 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 resident of Bulgaria the personal allowances for himself and his family that he would be permitted to take if the permanent establishment were a sole proprietorship owned and operated by a U.S. resident, despite the fact that the individual income tax rates would apply.

Paragraph 4

Paragraph 4 prohibits discrimination in the allowance of deductions. When a resident or an enterprise of a Contracting State pays interest, royalties or 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 resident or enterprise as if the payment had been made under the same conditions to a resident of the first-mentioned Contracting State. Paragraph 4, however, does not require a Contracting State to give non-residents more favorable treatment than it gives to its own residents. Consequently, a Contracting State does not have to allow non-residents a deduction for items that are not deductible under its domestic law (for example, expenses of a capital nature).

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.

An exception to the rule of paragraph 4 is provided for cases where the provisions of paragraph 1 of Article 9 (Associated Enterprises), paragraph 7 of Article 11 (Interest) or paragraph 6 of Article 12 (Royalties) apply. All of these provisions permit the denial of deductions in certain circumstances in respect of transactions between related persons. Neither State is

forced to apply the non-discrimination principle in such cases. The exception with respect to paragraph 7 of Article 11 would include the denial or deferral of certain interest deductions under Code section 163(j).

Paragraph 4 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-mentioned Contracting State for purposes of 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. Even though, for general purposes, the Convention covers only income taxes, under paragraph 7 of this Article, the nondiscrimination provisions apply to all taxes levied in both Contracting States, at all levels of government. Thus, this provision may be relevant for both States. Bulgaria may have capital taxes and in the United States such taxes frequently are imposed by local governments.

Paragraph 5

Paragraph 5 requires that a Contracting State not impose more burdensome taxation or connected requirements on 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 than the taxation or connected requirements that it imposes on other similar enterprises of that first-mentioned Contracting State. For this purpose it is understood that "similar" refers to similar activities or ownership of the enterprise.

This rule, like all non-discrimination provisions, does not prohibit differing treatment of entities that are in differing circumstances. Rather, a protected enterprise is only required to be treated in the same manner as other enterprises that, from the point of view of the application of the tax law, are in substantially similar circumstances both in law and in fact. The taxation of a distributing corporation under section 367(e) on an applicable distribution to foreign shareholders does not violate paragraph 5 of the Article because a foreign-owned corporation is not similar to a domestically-owned corporation that is accorded non-recognition treatment under sections 337 and 355.

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 5 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 5 of the Article. If a corporation elects to be an S corporation, 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 the protections of conducting 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. Similarly, the provisions 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 provision to permit individuals to conduct a business in corporate form at individual tax rates would not be furthered by their inclusion.

Finally, it is understood that paragraph 5 does not require a Contracting State to allow foreign corporations to join in filing a consolidated return with a domestic corporation or to allow similar benefits between domestic and foreign enterprises.

Paragraph 6

Paragraph 6 of the Article confirms that no provision of the Article will prevent either Contracting State from imposing either the branch profits tax described in paragraph 8 of Article 10 (Dividends) or the branch-level interest tax described in paragraph 9 of Article 11 (Interest).

Paragraph 7

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

Relationship to Other Articles

The saving clause of paragraph 4 of Article 1 (General Scope) does not apply to this Article by virtue of the exceptions in paragraph 5(a) of Article 1. Thus, for example, a U.S. citizen who is a resident of Bulgaria may claim benefits in the United States under this Article.

Nationals of a Contracting State may claim the benefits of paragraph 1 regardless of whether they are entitled to benefits under Article 21 (Limitation on Benefits), because that paragraph applies to nationals and not residents. They may not claim the benefits of the other paragraphs of this Article with respect to an item of income unless they are generally entitled to treaty benefits with respect to that income under a provision of Article 21.

ARTICLE 24 (MUTUAL AGREEMENT PROCEDURE)

This Article provides the mechanism for taxpayers to bring to the attention of competent authorities issues and problems that may arise under the Convention. It also provides the authority for cooperation between the competent authorities of the Contracting States to resolve disputes and clarify issues 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 paragraph 1(k) of Article 3 (General Definitions).

Paragraph 1

This paragraph provides that where a resident of a Contracting State considers that the actions of one or both Contracting States will result in taxation that is not in accordance with the Convention he may present his case to the competent authority of either Contracting State. This rule is more generous than in most treaties, which generally allow taxpayers to bring competent authority cases only to the competent authority of their country of residence, or citizenship/nationality. Under this more generous rule, a U.S. permanent establishment of a corporation resident in the treaty partner that faces inconsistent treatment in the two countries would be able to bring its request for assistance to the U.S. competent authority. If the U.S. competent authority can resolve the issue on its own, then the taxpayer need never involve the Bulgarian competent authority. Thus, the rule provides flexibility that might result in greater efficiency.

Although the typical cases brought under this paragraph will involve economic double taxation arising from transfer pricing adjustments, the scope of this paragraph is not limited to such cases. For example, a taxpayer could request assistance from the competent authority if one Contracting State determines that the taxpayer has received deferred compensation taxable at source under Article 14 (Income from Employment), while the taxpayer believes that such

income should be treated as a pension that is taxable only in his country of residence pursuant to Article 17 (Pensions, Social Security Payments, Annuities, Alimony, and Child Support).

It is not necessary for a person requesting assistance first to have exhausted the remedies provided under the national laws of the Contracting States before presenting a case to the competent authorities, nor does the fact that the statute of limitations may have passed for seeking a refund preclude bringing a case to the competent authority. Unlike the OECD Model, no time limit is provided within which a case must be brought.

Paragraph 2

Paragraph 2 sets out the framework within which the competent authorities will deal with cases brought by taxpayers under paragraph 1. It provides that, if the competent authority of the Contracting State to which the case is presented judges the case to have merit, and cannot reach a unilateral solution, it shall seek an agreement with the competent authority of the other Contracting State pursuant to which taxation not in accordance with the Convention will be avoided.

Any agreement is to be implemented even if such implementation otherwise would be barred by the statute of limitations or by some other procedural limitation, such as a closing agreement. Paragraph 2, however, does not prevent the application of domestic-law procedural limitations that give effect to the agreement (*e.g.*, a domestic-law requirement that the taxpayer file a return reflecting the agreement within one year of the date of the agreement). Where the taxpayer has entered a closing agreement (or other written settlement) with the United States before bringing a case to the competent authorities, the U.S. competent authority will endeavor only to obtain a correlative adjustment from Bulgaria. See Rev. Proc. 2006-54, 2006-2 C.B. 1035, Section 7.05.

Because, as specified in paragraph 2 of Article 1 (General Scope), the Convention cannot operate to increase a taxpayer's liability, temporal or other procedural limitations can be overridden only for the purpose of making refunds and not to impose additional tax. Under Bulgarian law, a taxpayer may secure payment of any tax due (for example, using a letter of credit) and need not pay the entire amount of tax due until the competent authorities resolve the case, while under U.S. law with respect to U.S. initiated adjustments the United States generally will postpone further administrative action with respect to the issues under competent authority consideration. See Rev. Proc. 2006-54, 2006-2 C.B. 1035, Section 7.01.

Paragraph 10 of the Protocol to the Convention sets forth two additional clarifications to the application of paragraph 2 of Article 24. First, the Protocol notes that an agreement reached would not affect any court proceedings or any final court decisions or final tax assessment acts. This provision of the paragraph is intended to address certain aspects of the relationship of mutual agreement procedures and judicial or assessment proceedings in Bulgaria.

Under Bulgarian law, a taxpayer may begin court proceedings either before or after it has made a request for assistance under this Article. The Protocol confirms that Bulgarian judicial proceedings involving mutual agreement procedure issues in question will not be inhibited merely by the initiation of a request for competent authority assistance. Moreover, any final judicial determination involving mutual agreement procedure issues may be set aside only if the requirements under Bulgarian law for revision or repeal of final acts are fulfilled. Similarly, if the Bulgarian revenue authority has finalized its tax assessment, irrespective of any judicial activity, a mutual agreement procedure cannot change that assessment unless the requirements under Bulgarian law for revision or repeal of final acts are fulfilled.

Under the Bulgarian law for revision or repeal of final acts, an assessment may be changed based on new information. The Treasury Department understands that Bulgaria will interpret broadly what constitutes "new information." For example, if an examination in Bulgaria is completed and closed, the Bulgarian competent authority may nonetheless accept a request for assistance based on new information, such as an adjustment in the United States.

Second, paragraph 10 of the Protocol notes that if an examination is completed and closed (and the subject of the mutual agreement procedure request is not a matter pending before a court or for which a settlement or court decision has been reached) in a Contracting State, that Contracting State's competent authority may nonetheless accept a request for assistance if an adjustment causing double taxation is made in the other Contracting State. This provision of the Protocol confirms that the Bulgarian competent authority can accept a mutual agreement procedure request based upon a US-initiated adjustment and can subsequently implement any resulting competent authority agreement, so long as the issue that is the subject of the mutual agreement procedure request is neither an issue presented to and pending before a Bulgarian court, nor one for which a Bulgarian judicial decision or litigation settlement has been concluded.

Paragraph 3

Paragraph 3 authorizes the competent authorities 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. This list is purely illustrative; it does not grant any authority that is not implicitly present as a result of the introductory sentence of paragraph 3.

The competent authorities may, for example, agree to the same allocation of income, deductions, credits or allowances between an enterprise in one Contracting State and its permanent establishment in the other or between related persons. These allocations are to be made in accordance with the arm's length principle underlying Article 7 (Business Profits) and Article 9 (Associated Enterprises). Agreements reached under these subparagraphs may include agreement on a methodology for determining an appropriate transfer price, on an acceptable range of results under that methodology, or on a common treatment of a taxpayer's cost sharing arrangement.

The competent authorities also may agree to settle a variety of conflicting applications of the Convention. They may agree to settle conflicts regarding the characterization of particular items of income, the characterization of persons, the application of source rules to particular items of income, or the meaning of a term. They also may agree as to advance pricing arrangements.

Since the list under paragraph 3 is not exhaustive, the competent authorities may reach agreement on issues not enumerated in paragraph 3 if necessary to avoid double taxation. For example, the competent authorities may seek agreement on a uniform set of standards for the use of exchange rates. Agreements reached by the competent authorities under paragraph 3 need not conform to the internal law provisions of either Contracting State.

Finally, paragraph 3 authorizes the competent authorities to consult for the purpose of eliminating double taxation in cases not provided for in the Convention and to resolve any difficulties or doubts arising as to the interpretation or application of the Convention. This provision is intended to permit the competent authorities to implement the treaty in particular cases in a manner that is consistent with its expressed general purposes. It permits the competent authorities to deal with cases that are within the spirit of the provisions but that are not specifically covered. 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 Bulgaria. Since no resident of a Contracting State is involved in the case, the Convention does not apply, but the competent authorities nevertheless may use the authority of this Article to prevent the double taxation of income.

Paragraph 4

Paragraph 4 authorizes the competent authorities to increase any dollar amounts referred to in the Convention to reflect economic and monetary developments. Under the Convention, this refers only to Article 16 (Entertainers and Sportsmen); Article 19 (Students, Trainees, Teachers and Researchers) separately instructs the competent authorities to adjust the exemption amount for students and trainees in accordance with specified guidelines. The rule under paragraph 4 is intended to operate as follows: if, for example, after the Convention has been in force for some time, inflation rates have been such as to make the $15,000 exemption threshold for entertainers unrealistically low in terms of the original objectives intended in setting the threshold, the competent authorities may agree to a higher threshold without the need for formal amendment to the treaty and ratification by the Contracting States. This authority can be exercised, however, only to the extent necessary to restore those original objectives. This provision can be applied only to the benefit of taxpayers (i.e., only to increase thresholds, not to reduce them).

Paragraph 5

Paragraph 5 provides that the competent authorities may communicate with each other for the purpose of reaching an agreement. This makes clear that the competent authorities of the two Contracting States may communicate without going through diplomatic channels. Such communication may be in various forms, including, where appropriate, through face-to-face meetings of representatives of the competent authorities.

Treaty termination in relation to competent authority dispute resolution

A case may be raised by a taxpayer after the Convention has been terminated with respect to a year for which the Convention was in force. In such a case the ability of the competent authorities to act is limited. They may not exchange confidential information, nor may they reach a solution that varies from that specified in its law.

Triangular competent authority solutions

International tax cases may involve more than two taxing jurisdictions (e.g., transactions among a parent corporation resident in country A and its subsidiaries resident in countries B and C). As long as there is a complete network of treaties among the three countries, it should be possible, under the full combination of bilateral authorities, for the competent authorities of the three States to work together on a three-sided solution. Although country A may not be able to give information received under Article 25 (Exchange of Information and Administrative Assistance) from country B to the authorities of country C, if the competent authorities of the three countries are working together, it should not be a problem for them to arrange for the authorities of country B to give the necessary information directly to the tax authorities of country C, as well as to those of country A. Each bilateral part of the trilateral solution must, of course, not exceed the scope of the authority of the competent authorities under the relevant bilateral treaty.

Relationship to Other Articles

This Article is not subject to the saving clause of paragraph 4 of Article 1 (General Scope) by virtue of the exceptions in paragraph 5(a) of that Article. Thus, rules, definitions, procedures, etc. that are agreed upon by the competent authorities under this Article may be applied by the United States with respect to its citizens and residents even if they differ from the comparable Code provisions. Similarly, as indicated above, U.S. law may be overridden to provide refunds of tax to a U.S. citizen or resident under this Article. A person may seek relief under Article 24 regardless of whether he is generally entitled to benefits under Article 21 (Limitation on Benefits). As in all other cases, the competent authority is vested with the discretion to decide whether the claim for relief is justified.

ARTICLE 25 (EXCHANGE OF INFORMATION AND ADMINISTRATIVE ASSISTANCE)

This Article provides for the exchange of information and administrative assistance between the competent authorities of the Contracting States.

Paragraph 1

The obligation to obtain and provide information to the other Contracting State is set out in paragraph 1. The information to be exchanged is that which may be relevant for carrying out the provisions of the Convention or the domestic laws of the United States or of Bulgaria concerning taxes of every kind applied at the national level. This language incorporates the standard in 26 U.S.C. section 7602 which authorizes the IRS to examine "any books, papers, records, or other data which may be relevant or material." (Emphasis added.) In United States v. Arthur Young & Co., 465 U.S. 805, 814 (1984), the Supreme Court stated that the language "may be" reflects Congress's express intention to allow the IRS to obtain "items of even potential relevance to an ongoing investigation, without reference to its admissibility." (Emphasis in original.) However, the language "may be" would not support a request in which a Contracting State simply asked for information regarding all bank accounts maintained by residents of that Contracting State in the other Contracting State, or even all accounts maintained by its residents with respect to a particular bank.

Exchange of information with respect to each State's domestic law is authorized to the extent that taxation under domestic law 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 to carry out the Convention. An example of such a case is provided in the OECD Commentary: a company resident in the United States and a company resident in Bulgaria transact business between themselves through a third-country resident company. Neither Contracting State has a treaty with the third State. To enforce their internal laws with respect to transactions of their residents with the third-country company (since there is no relevant treaty in force), the Contracting States may exchange information regarding the prices that their residents paid in their transactions with the third-country resident.

Paragraph 1 clarifies that information may be exchanged that relates to the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. Thus, the competent authorities may request and provide information for cases under examination or criminal investigation, in collection, on appeals, or under prosecution.

The taxes covered by the Convention for purposes of this Article constitute a broader category of taxes than those referred to in Article 2 (Taxes Covered). Exchange of information

is authorized with respect to taxes of every kind imposed by a Contracting State at the national level. Accordingly, information may be exchanged with respect to U.S. estate and gift taxes, excise taxes or, with respect to Bulgaria, value added taxes.

Information exchange is not restricted by paragraph 1 of Article 1 (General Scope). Accordingly, 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 Bulgaria, and that permanent establishment engages in transactions with a U.S. enterprise, the United States could request information with respect to that permanent establishment, even though the third-country resident is not a resident of either Contracting State. Similarly, if a third-country resident maintains a bank account in Bulgaria, 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 Bulgaria with respect to that person's account, even though that person is not the taxpayer under examination.

Although the term "United States" does not encompass U.S. possessions for most purposes of the Convention, section 7651 of the Code authorizes the Internal Revenue Service to utilize the provisions of the Internal Revenue Code to obtain information from the U.S. possessions pursuant to a proper request made under Article 25. If necessary to obtain requested information, the Internal Revenue Service could issue and enforce an administrative summons to the taxpayer, a tax authority (or a government agency in a U.S. possession), or a third party located in a U.S. possession.

Paragraph 2

Paragraph 2 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). The intention is to ensure that the information may be introduced as evidence 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 3

Paragraph 3 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, involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. The information must be used by these persons in connection with the specified functions. Information may also be disclosed to legislative bodies, such as the tax-writing committees of Congress and the Government Accountability Office, engaged in the oversight of the preceding activities. Information received by these bodies must be 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.

Paragraph 4

Paragraph 4 provides that the obligations undertaken in paragraphs 1, 2, and 3 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 a Contracting State required 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.

Thus, a requesting State may be denied information from the other State if the information would be obtained pursuant to procedures or measures that are broader than those available in the requesting State. However, the statute of limitations of the Contracting State making the request for information should govern a request for information. Thus, the Contracting State of which the request is made should attempt to obtain the information even if its own statute of limitations has passed. In many cases, relevant information will still exist in the business records of the taxpayer or a third party, even though it is no longer required to be kept for domestic tax purposes.

While paragraph 4 states conditions under which a Contracting State is not obligated to comply with a request from the other Contracting State for information, the requested State is not precluded from providing such information, and may, at its discretion, do so subject to the limitations of its internal law.

Paragraph 5

Paragraph 5 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. In the absence of such a paragraph, some taxpayers have argued that subparagraph 4(a) prevents a Contracting State from requesting information from a bank or fiduciary that the Contracting State does not need for its own tax purposes. This paragraph clarifies that paragraph 4 does not impose such a restriction and that a Contracting State is not limited to providing only the information that it already has in its own files.

Paragraph 6

Paragraph 6 provides that a Contracting State may not decline to provide information because that information is held by financial institutions, nominees or persons acting in an agency or fiduciary capacity. Thus, paragraph 6 would effectively prevent a Contracting State from relying on paragraph 4 to argue that its domestic bank secrecy laws (or similar legislation relating to disclosure of financial information by financial institutions or intermediaries) override its obligation to provide information under paragraph 1. This paragraph also requires the disclosure of information regarding the beneficial owner of an interest in a person, such as the identity of a beneficial owner of bearer shares.

Treaty effective dates and termination in relation to exchange of information

Once the Convention is in force, the competent authority may seek information under the Convention with respect to a year prior to the entry into force of the Convention. Even though no Convention was in effect during the years in which the transaction at issue occurred, the exchange of information provisions of the Convention shall have effect from the date of entry into force of the Convention without regard to the taxable period to which the matter relates. In that case, the competent authorities have available to them the full range of information exchange provisions afforded under this Article. Paragraph 11 of the Protocol, regarding Article 27 (Entry into Force), confirms this understanding with respect to the effective date of the Article.

A tax administration may also seek information with respect to a year for which a treaty was in force after the treaty has been terminated. In such a case the ability of the other tax

administration to act is limited. The treaty no longer provides authority for the tax administrations to exchange confidential information. They may only exchange information pursuant to domestic law or other international agreement or arrangement.

ARTICLE 26 (MEMBERS OF DIPLOMATIC MISSIONS AND CONSULAR POSTS)

This Article confirms 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. The agreements referred to include any bilateral agreements, such as consular conventions, that affect the taxation of diplomats and consular officials and any multilateral agreements dealing with these issues, such as the Vienna Convention on Diplomatic Relations and the Vienna Convention on Consular Relations. The U.S. generally adheres to the latter because its terms are consistent with customary international law.

The Article does not independently provide any benefits to diplomatic agents and consular officers. Article 18 (Government Service) does so, as do Code section 893 and a number of bilateral and multilateral agreements. In the event that there is a conflict between the Convention and international law or such other treaties, under which the diplomatic agent or consular official is entitled to greater benefits under the latter, the latter laws or agreements shall have precedence. Conversely, if the Convention confers a greater benefit than another agreement, the affected person could claim the benefit of the tax treaty.

Pursuant to subparagraph 5(b) of Article 1, the saving clause of paragraph 4 of Article 1 (General Scope) does not apply to override any benefits of this Article available to an individual who is neither a citizen of the United States nor has immigrant status in the United States.

ARTICLE 27 (ENTRY INTO FORCE)

This Article contains the rules for bringing the Convention into force and giving effect to its provisions.

Paragraph 1

Paragraph 1 provides that the Contracting States shall notify each other, through diplomatic channels, when their respective requirements for the entry into force of the Convention have been satisfied. The Convention shall enter into force on the date of receipt of the later of these notifications.

In the United States, the process leading to ratification and entry into force is as follows: Once a treaty has been signed by authorized representatives of the two Contracting States, the Department of State sends the treaty to the President who formally transmits it to the Senate for its advice and consent to ratification, which requires approval by two-thirds of the Senators present and voting. Prior to this vote, however, it generally has been the practice for the Senate Committee on Foreign Relations to hold hearings on the treaty and make a recommendation regarding its approval to the full Senate. Both Government and private sector witnesses may testify at these hearings. After the Senate gives its advice and consent to ratification of the treaty, an instrument of ratification is drafted for the President's signature. The President's signature completes the process in the United States.

Paragraph 2

The date on which a Convention enters into force is not necessarily the date on which its provisions take effect. Paragraph 2 contains rules that determine when the provisions of the Convention will have effect.

Under paragraph 2(a), the Convention will have effect with respect to taxes withheld at source (principally dividends, interest and royalties) for amounts paid or credited on or after the first day of January in the calendar year following the date on which the Convention enters into force. For example, if instruments of ratification are exchanged on April 25th of year 1, the withholding rates specified in paragraph 2 of Article 10 (Dividends) would be applicable to any dividends paid or credited on or after January 1 of year 2.

For all other taxes, paragraph 2(b) specifies that the Convention will have effect for any taxable period beginning on or after January 1 of the year following entry into force.

As discussed under Article 25 (Exchange of Information), the powers afforded under that article apply retroactively to taxable periods preceding entry into force.

ARTICLE 28 (TERMINATION)

The Convention is to remain in effect indefinitely, unless terminated by one of the Contracting States in accordance with the provisions of Article 28. For example, if written notice of termination is given through the diplomatic channel not later than June 30th of calendar year 1, the provisions of the Convention will cease to have effect with respect to taxes withheld at source on income paid or credited on or after January 1st of calendar year 2. For other taxes, the Convention will cease to have effect for any taxable period beginning on or after January 1st of calendar year 2.

Article 28 relates only to unilateral termination of the Convention by a Contracting State. Nothing in that Article should be construed as preventing the Contracting States from concluding a new bilateral agreement, subject to ratification, that supersedes, amends or terminates provisions of the Convention without the notification period.

Customary international law observed by the United States and other countries, as reflected in the Vienna Convention on Treaties, allows termination by one Contracting State at any time in the event of a "material breach" of the agreement by the other Contracting State.

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July 11, 2008
HP-1077

WEEK 11 WRAP-UP:
TREASURY SENT 7.530 MILLION STIMULUS PAYMENTS THIS WEEK

This week the Treasury Department sent out 7.530 million economic stimulus payments to American households totaling $5.755 billion. In total, Treasury has sent out 112.405 million total economic stimulus payments totaling $91.834 billion.

This week marks the final week of mass disbursements of stimulus payments. Payments will continue to be sent to households in small batches throughout the end of the year as returns are filed by the October 15 extension deadline. Those Americans who do not file by October 15 and still qualify for a payment can obtain their stimulus payment by filing a 2008 tax return next year.

Cumulative Total

Total Number of Payments: 112.405 million
Total Amount of Payments: $91.834 billion

Week Eleven (July 7-11)

Total Number of Payments: 7.530 million
Total Amount of Payments: $5.755 billion

Week Ten (June 30-July 4)

Total Number of Payments: 10.025 million
Total Amount of Payments: $7.775 billion

Week Nine (June 23-27)

Total Number of Payments: 9.674 million
Total Amount of Payments: $7.522 billion

Week Eight (June 16-20)

Total Number of Payments: 9.071 million
Total Amount of Payments: $6.919 billion

Week Seven (June 9-13)

Total Number of Payments: 9.526 million
Total Amount of Payments: $7.032 billion

Week Six (June 2-6)

Total Number of Payments: 9.143 million
Total Amount of Payments: $6.789 billion

Week Five (May 26-30)

Total Number of Payments: 5.757 million
Total Amount of Payments: $4.320 billion

Week Four (May 19-23)

Total Number of Payments: 6.211 million
Total Amount of Payments: $4.927 billion

Week Three (May 12-16)

Total Number of Payments: 15.575 million
Total Amount of Payments: $13.562 billion

Week Two (May 5-9)

Total Number of Payments: 22.180 million
Total Amount of Payments: $20.138 billion

Week One (April 28-May 2)

Total Number of Payments: 7.708 million
Total Amount of Payments: $7.091 billion

Payments began April 28 and will continue via direct deposit or paper check through mid-July. For a single filer, the minimum payment is generally $300 and the maximum payment is $600. For joint filers, the minimum is generally $600 and the maximum $1,200. There is also an additional $300 payment for each qualifying child.

For tax returns processed by the Internal Revenue Service by April 15 households will receive their payments according to the last two digits of the Social Security number on the tax form. On a joint return, the first number listed will determine when a stimulus payment will be sent.

REPORTS

- Direct Deposit Payments

Direct Deposit Payments

If the last two digits of your Social Security number are:	Your economic stimulus payment deposit should be transmitted to your bank account by:
00-20	May 2
21-75	May 9
76-99	May 16

Paper Check

If the last two digits of your Social Security number are:	Your check should be in the mail by:
00-09	May 16
10-18	May 23
19-25	May 30
26-38	June 6
39-51	June 13
52-63	June 20
64-75	June 27
76-87	July 4
88-99	July 11

A small percent of tax returns will require additional time to process and to compute a stimulus payment amount. For these returns, stimulus payments may not be issued in accordance with the schedule above, even if the tax return was processed by April 15. In these cases, the stimulus payment will be issued approximately 2 weeks after the tax return is ultimately processed.

July 11, 2008
HP-1078

Statement by Secretary Henry M. Paulson, Jr. on Fannie Mae and Freddie Mac

Washington, DC--Secretary Henry M. Paulson, Jr. made the following comment today on news stories about "contingency planning" at Treasury:

"Today our primary focus is supporting Fannie Mae and Freddie Mac in their current form as they carry out their important mission.

"We appreciate Congress' important efforts to complete legislation that will help promote confidence in these companies. We are maintaining a dialogue with regulators and with the companies. OFHEO will continue to work with the companies as they take the steps necessary to allow them to continue to perform their important public mission."

-30-

July 13, 2008
HP-1079

Paulson Announces GSE Initiatives

Washington, DC-- Treasury Secretary Henry M. Paulson, Jr. issued the following statement:

Fannie Mae and Freddie Mac play a central role in our housing finance system and must continue to do so in their current form as shareholder-owned companies. Their support for the housing market is particularly important as we work through the current housing correction.

GSE debt is held by financial institutions around the world. Its continued strength is important to maintaining confidence and stability in our financial system and our financial markets. Therefore we must take steps to address the current situation as we move to a stronger regulatory structure.

In recent days, I have consulted with the Federal Reserve, OFHEO, the SEC, Congressional leaders of both parties and with the two companies to develop a three-part plan for immediate action. The President has asked me to work with Congress to act on this plan immediately.

First, as a liquidity backstop, the plan includes a temporary increase in the line of credit the GSEs have with Treasury. Treasury would determine the terms and conditions for accessing the line of credit and the amount to be drawn.

Second, to ensure the GSEs have access to sufficient capital to continue to serve their mission, the plan includes temporary authority for Treasury to purchase equity in either of the two GSEs if needed.

Use of either the line of credit or the equity investment would carry terms and conditions necessary to protect the taxpayer.

Third, to protect the financial system from systemic risk going forward, the plan strengthens the GSE regulatory reform legislation currently moving through Congress by giving the Federal Reserve a consultative role in the new GSE regulator's process for setting capital requirements and other prudential standards.

I look forward to working closely with the Congressional leaders to enact this legislation as soon as possible, as one complete package.

-30-

PRESS ROOM

July 14, 2008
2008-7-14-17-17-49-22597

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $74,082 million as of the end of that week, compared to $74, 508 million as of the end of the prior week.

I. Official reserve assets and other foreign currency assets (approximate market value, in US millions)

	June 13, 2008		
A. Official reserve assets (in US millions unless otherwise specified) [1]	Euro	Yen	Total
(1) Foreign currency reserves (in convertible foreign currencies)			74,082
(a) Securities	9,797	11,831	21,628
of which: issuer headquartered in reporting country but located abroad			0
(b) total currency and deposits with:			
(i) other national central banks, BIS and IMF	14,579	5,842	20,421
ii) banks headquartered in the reporting country			0
of which: located abroad			0
(iii) banks headquartered outside the reporting country			0
of which: located in the reporting country			0
(2) IMF reserve position [2]	5,064		
(3) SDRs [2]	9,682		
(4) gold (including gold deposits and, if appropriate, gold swapped) [3]	11,041		
--volume in millions of fine troy ounces	261.499		
(5) other reserve assets (specify)	6,246		
--financial derivatives			
--loans to nonbank nonresidents			
--other (foreign currency assets invested through reverse repurchase agreements)	6,246		
B. Other foreign currency assets (specify)			
--securities not included in official reserve assets			
--deposits not included in official reserve assets			
--loans not included in official reserve assets			
--financial derivatives not included in official reserve assets			
--gold not included in official reserve assets			
--other			

II. Predetermined short-term net drains on foreign currency assets (nominal value)

			Maturity breakdown (residual maturity)		
		Total	Up to 1 month	More than 1 and up to 3 months	More than 3 months and up to 1 year
1. Foreign currency loans, securities, and deposits					
--outflows (-)	Principal				
	Interest				
--inflows (+)	Principal				
	Interest				
2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the domestic currency (including the forward leg of currency swaps)					
(a) Short positions (-) [4]		-62,000	-62,000		
(b) Long positions (+)					
3. Other (specify)					
--outflows related to repos (-)					
--inflows related to reverse repos (+)					
--trade credit (-)					
--trade credit (+)					
--other accounts payable (-)					
--other accounts receivable (+)					

III. Contingent short-term net drains on foreign currency assets (nominal value)

		Maturity breakdown (residual maturity, where applicable)		
	Total	Up to 1 month	More than 1 and up to 3 months	More than 3 months and up to 1 year
1. Contingent liabilities in foreign currency				
(a) Collateral guarantees on debt falling due within 1 year				
(b) Other contingent liabilities				
2. Foreign currency securities issued with embedded options (puttable bonds)				
3. Undrawn, unconditional credit lines provided by:				
(a) other national monetary authorities, BIS, IMF, and other international organizations				
--other national monetary authorities (+)				
--BIS (+)				
--IMF (+)				
(b) with banks and other financial institutions headquartered in the reporting country (+)				
(c) with banks and other financial institutions headquartered outside the reporting country (+)				
Undrawn, unconditional credit lines provided to:				
(a) other national monetary authorities, BIS, IMF, and other international organizations				
--other national monetary authorities (-)				

--BIS (-)				
--IMF (-)				
(b) banks and other financial institutions headquartered in reporting country (-)				
(c) banks and other financial institutions headquartered outside the reporting country (-)				
4. Aggregate short and long positions of options in foreign currencies vis-à-vis the domestic currency				
(a) Short positions				
(i) Bought puts				
(ii) Written calls				
(b) Long positions				
(i) Bought calls				
(ii) Written puts				
PRO MEMORIA: In-the-money options [1]				
(1) At current exchange rate				
(a) Short position				
(b) Long position				
(2) + 5 % (depreciation of 5%)				
(a) Short position				
(b) Long position				
(3) - 5 % (appreciation of 5%)				
(a) Short position				
(b) Long position				
(4) +10 % (depreciation of 10%)				
(a) Short position				
(b) Long position				
(5) - 10 % (appreciation of 10%)				
(a) Short position				
(b) Long position				
(6) Other (specify)				
(a) Short position				
(b) Long position				

IV. Memo items

(1) To be reported with standard periodicity and timeliness:	
(a) short-term domestic currency debt indexed to the exchange rate	
(b) financial instruments denominated in foreign currency and settled by other means (e.g., in domestic currency)	
--nondeliverable forwards	
--short positions	
--long positions	
--other instruments	
(c) pledged assets	
--included in reserve assets	
--included in other foreign currency assets	
(d) securities lent and on repo	6,375

--lent or repoed and included in Section I	
--lent or repoed but not included in Section I	
--borrowed or acquired and included in Section I	
--borrowed or acquired but not included in Section I	6,375
(e) financial derivative assets (net, marked to market)	
--forwards	
--futures	
--swaps	
--options	
--other	
(f) derivatives (forward, futures, or options contracts) that have a residual maturity greater than one year, which are subject to margin calls.	
--aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the domestic currency (including the forward leg of currency swaps)	
(a) short positions (–)	
(b) long positions (+)	
--aggregate short and long positions of options in foreign currencies vis-à-vis the domestic currency	
(a) short positions	
(i) bought puts	
(ii) written calls	
(b) long positions	
(i) bought calls	
(ii) written puts	
(2) To be disclosed less frequently:	
(a) currency composition of reserves (by groups of currencies)	74,082
--currencies in SDR basket	74,082
--currencies not in SDR basket	
--by individual currencies (optional)	

Notes:

1/ Includes holdings of the Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve's System Open Market Account (SOMA), valued at current market exchange rates. Foreign currency holdings listed as securities reflect marked-to-market values, and deposits reflect carrying values.

2/ The items, "2. IMF Reserve Position" and "3. Special Drawing Rights (SDRs)," are based on data provided by the IMF and are valued in dollar terms at the official SDR/dollar exchange rate for the reporting date. The entries for the latest week reflect any necessary adjustments, including revaluation, by the U.S. Treasury to IMF data for the prior month end.

3/ Gold stock is valued monthly at $42.2222 per fine troy ounce.

4/ The short positions reflect foreign exchange acquired under reciprocal currency arrangements with certain foreign central banks. The foreign exchange acquired is not included in Section I, "official reserve assets and other foreign currency assets," of the template for reporting international reserves. However, it is included in the broader balance of payments presentation as "U.S. Government assets, other than official reserve assets/U.S. foreign currency holdings and U.S. short-term assets."

PRESS ROOM

July 14, 2008
2008-7-14-17-25-16-22669

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $74,867 million as of the end of that week, compared to $74,082 million as of the end of the prior week.

I. Official reserve assets and other foreign currency assets (approximate market value, in US millions)

	June 20, 2008		
A. Official reserve assets (in US millions unless otherwise specified) [1]	Euro	Yen	Total
(1) Foreign currency reserves (in convertible foreign currencies)			74,867
(a) Securities	9,967	11,905	21,872
of which: issuer headquartered in reporting country but located abroad			0
(b) total currency and deposits with:			
(i) other national central banks, BIS and IMF	14,811	5,872	20,683
ii) banks headquartered in the reporting country			0
of which: located abroad			0
(iii) banks headquartered outside the reporting country			0
of which: located in the reporting country			0
(2) IMF reserve position [2]	5,114		
(3) SDRs [2]	9,776		
(4) gold (including gold deposits and, if appropriate, gold swapped) [3]	11,041		
--volume in millions of fine troy ounces	261.499		
(5) other reserve assets (specify)	6,381		
--financial derivatives			
--loans to nonbank nonresidents			
--other (foreign currency assets invested through reverse repurchase agreements)	6,381		
B. Other foreign currency assets (specify)			
--securities not included in official reserve assets			
--deposits not included in official reserve assets			
--loans not included in official reserve assets			
--financial derivatives not included in official reserve assets			
--gold not included in official reserve assets			
--other			

II. Predetermined short-term net drains on foreign currency assets (nominal value)

			Maturity breakdown (residual maturity)		
		Total	Up to 1 month	More than 1 and up to 3 months	More than 3 months and up to 1 year
1. Foreign currency loans, securities, and deposits					
--outflows (-)	Principal				
	Interest				
--inflows (+)	Principal				
	Interest				
2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the domestic currency (including the forward leg of currency swaps)					
(a) Short positions (-) [4]		-62,000	-62,000		
(b) Long positions (+)					
3. Other (specify)					
--outflows related to repos (-)					
--inflows related to reverse repos (+)					
--trade credit (-)					
--trade credit (+)					
--other accounts payable (-)					
--other accounts receivable (+)					

III. Contingent short-term net drains on foreign currency assets (nominal value)

		Maturity breakdown (residual maturity, where applicable)		
	Total	Up to 1 month	More than 1 and up to 3 months	More than 3 months and up to 1 year
1. Contingent liabilities in foreign currency				
(a) Collateral guarantees on debt falling due within 1 year				
(b) Other contingent liabilities				
2. Foreign currency securities issued with embedded options (puttable bonds)				
3. Undrawn, unconditional credit lines provided by:				
(a) other national monetary authorities, BIS, IMF, and other international organizations				
--other national monetary authorities (+)				
--BIS (+)				
--IMF (+)				
(b) with banks and other financial institutions headquartered in the reporting country (+)				
(c) with banks and other financial institutions headquartered outside the reporting country (+)				
Undrawn, unconditional credit lines provided to:				
(a) other national monetary authorities, BIS, IMF, and other international organizations				
--other national monetary authorities (-)				

--BIS (-)				
--IMF (-)				
(b) banks and other financial institutions headquartered in reporting country (-)				
(c) banks and other financial institutions headquartered outside the reporting country (-)				
4. Aggregate short and long positions of options in foreign currencies vis-à-vis the domestic currency				
(a) Short positions				
(i) Bought puts				
(ii) Written calls				
(b) Long positions				
(i) Bought calls				
(ii) Written puts				
PRO MEMORIA: In-the-money options [11]				
(1) At current exchange rate				
(a) Short position				
(b) Long position				
(2) + 5 % (depreciation of 5%)				
(a) Short position				
(b) Long position				
(3) - 5 % (appreciation of 5%)				
(a) Short position				
(b) Long position				
(4) +10 % (depreciation of 10%)				
(a) Short position				
(b) Long position				
(5) - 10 % (appreciation of 10%)				
(a) Short position				
(b) Long position				
(6) Other (specify)				
(a) Short position				
(b) Long position				

IV. Memo items

(1) To be reported with standard periodicity and timeliness:	
(a) short-term domestic currency debt indexed to the exchange rate	
(b) financial instruments denominated in foreign currency and settled by other means (e.g., in domestic currency)	
--nondeliverable forwards	
--short positions	
--long positions	
--other instruments	
(c) pledged assets	
--included in reserve assets	
--included in other foreign currency assets	
(d) securities lent and on repo	6,518

--lent or repoed and included in Section I	
--lent or repoed but not included in Section I	
--borrowed or acquired and included in Section I	
--borrowed or acquired but not included in Section I	6,518
(e) financial derivative assets (net, marked to market)	
--forwards	
--futures	
--swaps	
--options	
--other	
(f) derivatives (forward, futures, or options contracts) that have a residual maturity greater than one year, which are subject to margin calls.	
--aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the domestic currency (including the forward leg of currency swaps)	
(a) short positions (–)	
(b) long positions (+)	
--aggregate short and long positions of options in foreign currencies vis-à-vis the domestic currency	
(a) short positions	
(i) bought puts	
(ii) written calls	
(b) long positions	
(i) bought calls	
(ii) written puts	
(2) To be disclosed less frequently:	
(a) currency composition of reserves (by groups of currencies)	74,867
--currencies in SDR basket	74,867
--currencies not in SDR basket	
--by individual currencies (optional)	

Notes:

1/ Includes holdings of the Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve's System Open Market Account (SOMA), valued at current market exchange rates. Foreign currency holdings listed as securities reflect marked-to-market values, and deposits reflect carrying values.

2/ The items, "2. IMF Reserve Position" and "3. Special Drawing Rights (SDRs)," are based on data provided by the IMF and are valued in dollar terms at the official SDR/dollar exchange rate for the reporting date. The entries for the latest week reflect any necessary adjustments, including revaluation, by the U.S. Treasury to IMF data for the prior month end.

3/ Gold stock is valued monthly at $42.2222 per fine troy ounce.

4/ The short positions reflect foreign exchange acquired under reciprocal currency arrangements with certain foreign central banks. The foreign exchange acquired is not included in Section I, "official reserve assets and other foreign currency assets," of the template for reporting international reserves. However, it is included in the broader balance of payments presentation as "U.S. Government assets, other than official reserve assets/U.S. foreign currency holdings and U.S. short-term assets."

PRESS ROOM

July 14, 2008
2008-7-14-17-39-30-22843

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $75,461 million as of the end of that week, compared to $74,867 million as of the end of the prior week.

I. Official reserve assets and other foreign currency assets (approximate market value, in US millions)

	June 27, 2008		
A. Official reserve assets (in US millions unless otherwise specified) [1]	Euro	Yen	Total
(1) Foreign currency reserves (in convertible foreign currencies)			75,461
(a) Securities	10,090	12,053	22,143
of which: issuer headquartered in reporting country but located abroad			0
(b) total currency and deposits with:			
(i) other national central banks, BIS and IMF	14,696	5,936	20,632
ii) banks headquartered in the reporting country			0
of which: located abroad			0
(iii) banks headquartered outside the reporting country			0
of which: located in the reporting country			0
(2) IMF reserve position [2]	5,140		
(3) SDRs [2]	9,827		
(4) gold (including gold deposits and, if appropriate, gold swapped) [3]	11,041		
--volume in millions of fine troy ounces	261.499		
(5) other reserve assets (specify)	6,678		
--financial derivatives			
--loans to nonbank nonresidents			
--other (foreign currency assets invested through reverse repurchase agreements)	6,678		
B. Other foreign currency assets (specify)			
--securities not included in official reserve assets			
--deposits not included in official reserve assets			
--loans not included in official reserve assets			
--financial derivatives not included in official reserve assets			
--gold not included in official reserve assets			
--other			

II. Predetermined short-term net drains on foreign currency assets (nominal value)

			Maturity breakdown (residual maturity)		
		Total	Up to 1 month	More than 1 and up to 3 months	More than 3 months and up to 1 year
1. Foreign currency loans, securities, and deposits					
--outflows (-)	Principal				
	Interest				
--inflows (+)	Principal				
	Interest				
2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the domestic currency (including the forward leg of currency swaps)					
(a) Short positions (-) [4]		-62,000	-62,000		
(b) Long positions (+)					
3. Other (specify)					
--outflows related to repos (-)					
--inflows related to reverse repos (+)					
--trade credit (-)					
--trade credit (+)					
--other accounts payable (-)					
--other accounts receivable (+)					

III. Contingent short-term net drains on foreign currency assets (nominal value)

		Maturity breakdown (residual maturity, where applicable)		
	Total	Up to 1 month	More than 1 and up to 3 months	More than 3 months and up to 1 year
1. Contingent liabilities in foreign currency				
(a) Collateral guarantees on debt falling due within 1 year				
(b) Other contingent liabilities				
2. Foreign currency securities issued with embedded options (puttable bonds)				
3. Undrawn, unconditional credit lines provided by:				
(a) other national monetary authorities, BIS, IMF, and other international organizations				
--other national monetary authorities (+)				
--BIS (+)				
--IMF (+)				
(b) with banks and other financial institutions headquartered in the reporting country (+)				
(c) with banks and other financial institutions headquartered outside the reporting country (+)				
Undrawn, unconditional credit lines provided to:				
(a) other national monetary authorities, BIS, IMF, and other international organizations				
--other national monetary authorities (-)				

--BIS (-)				
--IMF (-)				
(b) banks and other financial institutions headquartered in reporting country (-)				
(c) banks and other financial institutions headquartered outside the reporting country (-)				
4. Aggregate short and long positions of options in foreign currencies vis-à-vis the domestic currency				
(a) Short positions				
(i) Bought puts				
(ii) Written calls				
(b) Long positions				
(i) Bought calls				
(ii) Written puts				
PRO MEMORIA: In-the-money options [11]				
(1) At current exchange rate				
(a) Short position				
(b) Long position				
(2) + 5 % (depreciation of 5%)				
(a) Short position				
(b) Long position				
(3) - 5 % (appreciation of 5%)				
(a) Short position				
(b) Long position				
(4) +10 % (depreciation of 10%)				
(a) Short position				
(b) Long position				
(5) - 10 % (appreciation of 10%)				
(a) Short position				
(b) Long position				
(6) Other (specify)				
(a) Short position				
(b) Long position				

IV. Memo items

(1) To be reported with standard periodicity and timeliness:	
(a) short-term domestic currency debt indexed to the exchange rate	
(b) financial instruments denominated in foreign currency and settled by other means (e.g., in domestic currency)	
--nondeliverable forwards	
--short positions	
--long positions	
--other instruments	
(c) pledged assets	
--included in reserve assets	
--included in other foreign currency assets	
(d) securities lent and on repo	6,817

--lent or repoed and included in Section I	
--lent or repoed but not included in Section I	
--borrowed or acquired and included in Section I	
--borrowed or acquired but not included in Section I	6,817
(e) financial derivative assets (net, marked to market)	
--forwards	
--futures	
--swaps	
--options	
--other	
(f) derivatives (forward, futures, or options contracts) that have a residual maturity greater than one year, which are subject to margin calls.	
--aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the domestic currency (including the forward leg of currency swaps)	
(a) short positions (–)	
(b) long positions (+)	
--aggregate short and long positions of options in foreign currencies vis-à-vis the domestic currency	
(a) short positions	
(i) bought puts	
(ii) written calls	
(b) long positions	
(i) bought calls	
(ii) written puts	
(2) To be disclosed less frequently:	
(a) currency composition of reserves (by groups of currencies)	75,461
--currencies in SDR basket	75,461
--currencies not in SDR basket	
--by individual currencies (optional)	

Notes:

1/ Includes holdings of the Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve's System Open Market Account (SOMA), valued at current market exchange rates. Foreign currency holdings listed as securities reflect marked-to-market values, and deposits reflect carrying values.

2/ The items, "2. IMF Reserve Position" and "3. Special Drawing Rights (SDRs)," are based on data provided by the IMF and are valued in dollar terms at the official SDR/dollar exchange rate for the reporting date. The entries for the latest week reflect any necessary adjustments, including revaluation, by the U.S. Treasury to IMF data for the prior month end.

3/ Gold stock is valued monthly at $42.2222 per fine troy ounce.

4/ The short positions reflect foreign exchange acquired under reciprocal currency arrangements with certain foreign central banks. The foreign exchange acquired is not included in Section I, "official reserve assets and other foreign currency assets," of the template for reporting international reserves. However, it is included in the broader balance of payments presentation as "U.S. Government assets, other than official reserve assets/U.S. foreign currency holdings and U.S. short-term assets."

PRESS ROOM

July 14, 2008
2008-7-14-17-44-45-22885

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $75,266 million as of the end of that week, compared to $75,461 million as of the end of the prior week.

I. Official reserve assets and other foreign currency assets (approximate market value, in US millions)

	July 4, 2008		
A. Official reserve assets (in US millions unless otherwise specified) [1]	Euro	Yen	Total
(1) Foreign currency reserves (in convertible foreign currencies)			75,266
(a) Securities	10,062	11,989	22,051
of which: issuer headquartered in reporting country but located abroad			0
(b) total currency and deposits with:			
(i) other national central banks, BIS and IMF	14,655	5,908	20,563
ii) banks headquartered in the reporting country			0
of which: located abroad			0
(iii) banks headquartered outside the reporting country			0
of which: located in the reporting country			0
(2) IMF reserve position [2]	5,129		
(3) SDRs [2]	9,805		
(4) gold (including gold deposits and, if appropriate, gold swapped) [3]	11,041		
--volume in millions of fine troy ounces	261.499		
(5) other reserve assets (specify)	6,678		
--financial derivatives			
--loans to nonbank nonresidents			
--other (foreign currency assets invested through reverse repurchase agreements)	6,678		
B. Other foreign currency assets (specify)			
--securities not included in official reserve assets			
--deposits not included in official reserve assets			
--loans not included in official reserve assets			
--financial derivatives not included in official reserve assets			
--gold not included in official reserve assets			
--other			

II. Predetermined short-term net drains on foreign currency assets (nominal value)

			Maturity breakdown (residual maturity)		
		Total	Up to 1 month	More than 1 and up to 3 months	More than 3 months and up to 1 year
1. Foreign currency loans, securities, and deposits					
--outflows (-)	Principal				
	Interest				
--inflows (+)	Principal				
	Interest				
2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the domestic currency (including the forward leg of currency swaps)					
(a) Short positions (-) [4]		-62,000	-62,000		
(b) Long positions (+)					
3. Other (specify)					
--outflows related to repos (-)					
--inflows related to reverse repos (+)					
--trade credit (-)					
--trade credit (+)					
--other accounts payable (-)					
--other accounts receivable (+)					

III. Contingent short-term net drains on foreign currency assets (nominal value)

		Maturity breakdown (residual maturity, where applicable)		
	Total	Up to 1 month	More than 1 and up to 3 months	More than 3 months and up to 1 year
1. Contingent liabilities in foreign currency				
(a) Collateral guarantees on debt falling due within 1 year				
(b) Other contingent liabilities				
2. Foreign currency securities issued with embedded options (puttable bonds)				
3. Undrawn, unconditional credit lines provided by:				
(a) other national monetary authorities, BIS, IMF, and other international organizations				
--other national monetary authorities (+)				
--BIS (+)				
--IMF (+)				
(b) with banks and other financial institutions headquartered in the reporting country (+)				
(c) with banks and other financial institutions headquartered outside the reporting country (+)				
Undrawn, unconditional credit lines provided to:				
(a) other national monetary authorities, BIS, IMF, and other international organizations				
--other national monetary authorities (-)				

--BIS (-)				
--IMF (-)				
(b) banks and other financial institutions headquartered in reporting country (-)				
(c) banks and other financial institutions headquartered outside the reporting country (-)				
4. Aggregate short and long positions of options in foreign currencies vis-à-vis the domestic currency				
(a) Short positions				
(i) Bought puts				
(ii) Written calls				
(b) Long positions				
(i) Bought calls				
(ii) Written puts				
PRO MEMORIA: In-the-money options [1]				
(1) At current exchange rate				
(a) Short position				
(b) Long position				
(2) + 5 % (depreciation of 5%)				
(a) Short position				
(b) Long position				
(3) - 5 % (appreciation of 5%)				
(a) Short position				
(b) Long position				
(4) +10 % (depreciation of 10%)				
(a) Short position				
(b) Long position				
(5) - 10 % (appreciation of 10%)				
(a) Short position				
(b) Long position				
(6) Other (specify)				
(a) Short position				
(b) Long position				

IV. Memo items

(1) To be reported with standard periodicity and timeliness:	
(a) short-term domestic currency debt indexed to the exchange rate	
(b) financial instruments denominated in foreign currency and settled by other means (e.g., in domestic currency)	
--nondeliverable forwards	
--short positions	
--long positions	
--other instruments	
(c) pledged assets	
--included in reserve assets	
--included in other foreign currency assets	
(d) securities lent and on repo	6,811

--lent or repoed and included in Section I	
--lent or repoed but not included in Section I	
--borrowed or acquired and included in Section I	
--borrowed or acquired but not included in Section I	6,811
(e) financial derivative assets (net, marked to market)	
--forwards	
--futures	
--swaps	
--options	
--other	
(f) derivatives (forward, futures, or options contracts) that have a residual maturity greater than one year, which are subject to margin calls.	
--aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the domestic currency (including the forward leg of currency swaps)	
(a) short positions (–)	
(b) long positions (+)	
--aggregate short and long positions of options in foreign currencies vis-à-vis the domestic currency	
(a) short positions	
(i) bought puts	
(ii) written calls	
(b) long positions	
(i) bought calls	
(ii) written puts	
(2) To be disclosed less frequently:	
(a) currency composition of reserves (by groups of currencies)	75,266
--currencies in SDR basket	75,266
--currencies not in SDR basket	
--by individual currencies (optional)	

Notes:

1/ Includes holdings of the Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve's System Open Market Account (SOMA), valued at current market exchange rates. Foreign currency holdings listed as securities reflect marked-to-market values, and deposits reflect carrying values.

2/ The items, "2. IMF Reserve Position" and "3. Special Drawing Rights (SDRs)," are based on data provided by the IMF and are valued in dollar terms at the official SDR/dollar exchange rate for the reporting date. The entries for the latest week reflect any necessary adjustments, including revaluation, by the U.S. Treasury to IMF data for the prior month end.

3/ Gold stock is valued monthly at $42.2222 per fine troy ounce.

4/ The short positions reflect foreign exchange acquired under reciprocal currency arrangements with certain foreign central banks. The foreign exchange acquired is not included in Section I, "official reserve assets and other foreign currency assets," of the template for reporting international reserves. However, it is included in the broader balance of payments presentation as "U.S. Government assets, other than official reserve assets/U.S. foreign currency holdings and U.S. short-term assets."

July 11, 2008
HP-1078

Statement by Secretary Henry M. Paulson, Jr. on Fannie Mae and Freddie Mac

Washington, DC--Secretary Henry M. Paulson, Jr. made the following comment today on news stories about "contingency planning" at Treasury:

"Today our primary focus is supporting Fannie Mae and Freddie Mac in their current form as they carry out their important mission.

"We appreciate Congress' important efforts to complete legislation that will help promote confidence in these companies. We are maintaining a dialogue with regulators and with the companies. OFHEO will continue to work with the companies as they take the steps necessary to allow them to continue to perform their important public mission."

-30-

July 13, 2008
HP-1079

Paulson Announces GSE Initiatives

Washington, DC-- Treasury Secretary Henry M. Paulson, Jr. issued the following statement:

Fannie Mae and Freddie Mac play a central role in our housing finance system and must continue to do so in their current form as shareholder-owned companies. Their support for the housing market is particularly important as we work through the current housing correction.

GSE debt is held by financial institutions around the world. Its continued strength is important to maintaining confidence and stability in our financial system and our financial markets. Therefore we must take steps to address the current situation as we move to a stronger regulatory structure.

In recent days, I have consulted with the Federal Reserve, OFHEO, the SEC, Congressional leaders of both parties and with the two companies to develop a three-part plan for immediate action. The President has asked me to work with Congress to act on this plan immediately.

First, as a liquidity backstop, the plan includes a temporary increase in the line of credit the GSEs have with Treasury. Treasury would determine the terms and conditions for accessing the line of credit and the amount to be drawn.

Second, to ensure the GSEs have access to sufficient capital to continue to serve their mission, the plan includes temporary authority for Treasury to purchase equity in either of the two GSEs if needed.

Use of either the line of credit or the equity investment would carry terms and conditions necessary to protect the taxpayer.

Third, to protect the financial system from systemic risk going forward, the plan strengthens the GSE regulatory reform legislation currently moving through Congress by giving the Federal Reserve a consultative role in the new GSE regulator's process for setting capital requirements and other prudential standards.

I look forward to working closely with the Congressional leaders to enact this legislation as soon as possible, as one complete package.

-30-

July 15, 2008
HP-1080

**Testimony by Secretary Henry M. Paulson, Jr.
on GSE Initiatives
before the Senate Banking Committee**

Washington-- Good morning. Thank you Chairman Dodd, Senator Shelby and committee members for your leadership and for the opportunity to discuss these important issues.

As you know, our financial markets have been experiencing turmoil since last August. It will take additional time to work through challenges and progress has not come in a straight line. However, our financial institutions are repricing risk, de-leveraging, recognizing losses, raising capital and seeking to improve their financial positions. And policy makers and regulators are vigilant in their efforts to address the current challenges.

Fannie Mae and Freddie Mac, two of the government-sponsored enterprises (GSEs), are also working through this challenging period. Fannie and Freddie play a central role in our housing finance system and must continue to do so in their current form as shareholder-owned companies. Their role in the housing market is particularly important as we work through the current housing correction. The GSEs now touch 70 percent of new mortgages and represent the only functioning secondary mortgage market. The GSEs are central to the availability of housing finance, which will determine the pace at which we emerge from this housing correction.

In addition, debt and other securities issued by the GSEs are held by financial institutions around the world. Continued confidence in the GSEs is important to maintaining financial system and market stability.

Market stability and support for housing finance are among my highest priorities during this time of stress in our markets. Therefore, after consultations with the Federal Reserve, the Office of Federal Housing Enterprise Oversight (OFHEO), the Securities and Exchange Commission (SEC) and Congressional leaders we are asking Congress, as it completes its work on a stronger GSE regulatory structure, to also enact a three-part plan to address the current situation. Our plan is aimed at supporting the stability of financial markets, not just these two enterprises. This is consistent with Treasury's mission to promote the market stability, orderliness and liquidity necessary to support our economy.

Our proposal was not prompted by any sudden deterioration in conditions at Fannie Mae or Freddie Mac. OFHEO has reaffirmed that both GSEs remain adequately capitalized. At the same time, recent developments convinced policymakers and the GSEs that steps are needed to respond to market concerns and increase confidence by providing assurances of access to liquidity and capital on a temporary basis if necessary.

The plan we announced will strengthen our financial system as we weather this housing correction and establish a new world class regulator for the GSEs; it has three parts.

First, as a liquidity backstop, the plan includes an 18-month temporary increase in Treasury's existing authority to make credit available for the GSEs. Given the difficulty in determining the appropriate size of the credit line we are not proposing a particular dollar amount. Flexibility is the best means of increasing market confidence in the GSEs, and also the best means of minimizing taxpayer risk.

Second, to ensure the GSEs have access to sufficient capital to continue to fulfill

their mission, the plan gives Treasury an 18-month temporary authority to purchase – only if necessary – equity in either of the two GSEs.

Let me stress that there are no immediate plans to access either the proposed liquidity or the proposed capital backstop. If either of these authorities is used, it would be done so only at Treasury's discretion, under terms and conditions that protect the U.S. taxpayer and are agreed to by both Treasury and the GSE. I have for some time urged a broad range of financial institutions to raise capital and at Treasury we have constantly encouraged the GSEs to do just that. In March, at my request, both the Chairman and Ranking Member of this Committee hosted a meeting with me and the CEOs of the two GSEs where they agreed to raise capital and you began the effort to move your GSE reform bill, which is now hopefully about to be enacted with the modifications we are recommending today.

Third, to help protect the financial system from future systemic risk, the plan strengthens the GSE regulatory reform legislation currently moving through Congress by providing the Federal Reserve authority to access information and perform a consultative role in the new GSE regulator's process for setting capital requirements and other prudential standards. Let me be clear, the Federal Reserve would not be the primary regulator. As I have said for some time, the Fed already plays the role of de-facto market stability regulator and we must give it the authorities to carry out that role. This role for the Federal Reserve with respect to the GSEs is consistent with the recommendation made in Treasury's Blueprint for a Modernized Financial Regulatory Structure. Clearly, given the scope of the GSEs' operations in world financial markets, a market stability regulator must have some line of sight into their operations.

We have long maintained that the GSEs have the potential to pose a systemic risk and worked with Congress on legislation to create a GSE regulator with authorities appropriate to the task and on par with other financial regulators. We must complete this work. The Senate passed GSE reform legislation last Friday, and we urge the House to act quickly to advance this process.

As I have said, we support the current shareholder-owned structure of these enterprises. Our plan addresses current market challenges by ensuring, on a temporary basis, access to both liquidity and capital, while also ensuring that the GSEs can fulfill their mission – a mission that remains critical to homeowners and homebuyers across the country, especially during this housing correction.

I look forward to working closely with you, your colleagues in the House, and Congressional leadership in both chambers to enact this plan as part of a complete legislative package, as soon as possible. Thank you.

-30-

July 15, 2008
HP-1081

Assistant Secretary for International Affairs Clay Lowery
Remarks to the African Growth and Opportunity Act Forum

Washington - Good afternoon. First, allow me to convey the regrets of Secretary Paulson, who had been looking forward to addressing you today. I had the privilege to accompany the Secretary on his visit to Africa last November, and so know first-hand how impressed he was by Africa's economic progress and how much he wanted to share his enthusiasm about Africa at this Forum. I will attempt today to convey to you his strong sense of optimism for the progress he has seen on the continent as well as his recommendations for maintaining this positive momentum.

It is wonderful to be here to speak at an event that helps to deepen the economic ties between Africa and the United States. I am also honored to be joined by Ngozi Okonjo-Iweala and Tom Gibian, both leaders and innovators in promoting African capital market development. The presence of so many people dedicated to supporting Africa's next steps forward is inspiring to all of us who recognize the promise of Africa's future.

Over the past 18 years, I've had the privilege to represent an NGO as well as the U.S. government – from the Treasury Department and the Millennium Challenge Corporation – in about 15 different African countries. I have worked with governments, NGOs and the private sector in those countries, and no matter the issue – my experience has always been fascinating and rewarding. I am especially pleased to be here today since I intend to make another trip to Africa in the fall. This forum – including the breakout workshops – provides the U.S. Treasury a chance to discuss financial sector development with African leaders and with private sector representatives keen to expand into the continent.

Again, I had the privilege to join Secretary Paulson and many of you last November at the U.S.-Africa Business Summit in Cape Town. I also accompanied the Secretary on memorable stops in Ghana, Tanzania, and South Africa, where we met with government representatives and business leaders. We were impressed by the major economic achievements that Africa has realized as well as the opportunities for continued advancement, and the Secretary expressed his desire to continue shining a light on your progress.

Shining a Light on Africa's Achievements

Investment flows to sub-Saharan Africa have been increasing at an astonishing rate. As a result of better macroeconomic policies, high commodity prices, and a renewed interest by investors seeking opportunity on the continent, private capital flows to the region have increased from just $11 billion in 2000 to $53 billion in 2007 – almost five-fold over seven years. As investors expand their horizons, more and more countries in Africa are being transformed by the flow of capital. Oil-producing countries continue to attract the bulk of foreign investment, but there are many other well-managed economies – such as Ghana, Zambia, Tanzania, Mozambique and Uganda – which are also reaping the benefits.

I would like to take a moment to highlight just a few of the successes that Africa has achieved.

Just since 2000, annual growth in sub-Saharan Africa has accelerated from four percent to over six percent, while inflation has declined markedly. External debt levels have plummeted, due in part to generous debt relief. And, foreign exchange reserves have almost doubled relative to imports.

And last month, the Kenyan government successfully sold a quarter of the shares of

Safaricom – its joint venture with Britain's Vodafone. The IPO raised $800 million for the Kenyan government and was four times oversubscribed. Safaricom's shares are now trading well above their issue price. The inflow of capital allows the company to invest in new technologies to serve the Kenyan people.

Ghana is another country making great strides. The country issued an external bond last September. This was the first such issuance by a sub-Saharan African country – outside South Africa – in nearly 30 years. The $750 million, 10-year bond was four times oversubscribed and continues to trade well above par. More important, this landmark transaction will enable the Ghanaians to invest in infrastructure -- the kind of investment that so much of Africa so desperately needs.

Gabon also issued its own Eurobond in December 2007, and other countries, including Kenya, are developing bond initiatives to help finance infrastructure development.

And, in our view, most promising of all is that private capital flows to Africa now exceed official development assistance. This transformation has changed the conversation on African development. Last April, Secretary Paulson had a chance to meet here in Washington for a discussion with six African finance ministers. What he heard he found most impressive: not requests for more aid, but instead questions about how to better attract private American investment. Some of these questions are being answered in the Forum's panel discussions today.

What can African governments do to attract investment?

Of course, while the growth of capital flows to Africa has been impressive, the continent's share of total global capital inflows – $6.4 trillion in 2007 – remains tiny. African nations can take additional steps to attract private investment that fuels growth.

What reforms are most critical in the eyes of private investors? We believe three areas should be the focus of African governments:

- First, maintaining macroeconomic stability;
- Second, developing local financial markets with sound regulatory systems;
- And third, removing obstacles to foreign investment in the financial sector.

1. Maintaining Macroeconomic Stability

In the first area, not surprisingly, countries with stable, well-managed economies with robust growth tend to attract greater foreign investment. There is an extensive body of academic studies that ties strengthening economic growth with increased capital flows. Sub-Saharan Africa is no exception. Many African countries are making progress, enacting monetary and fiscal reforms that have brought about macroeconomic stability and enabled the robust economic growth of recent years.

African economies are now facing new challenges, including steep rises in the costs of food and fuel. Understandably, governments are looking to mitigate the impact of these rising costs on their people. In doing so, they should avoid endangering their hard-won improvements in macroeconomic stability. Failure to protect these gains risks a return to high rates of inflation, expanding current account deficits and depreciating currencies, all of which would drain investor confidence and deprive these countries of the capital they need for their economic development.

2. Developing local financial markets and sound financial regulatory systems

Robust macroeconomic performance, however, is not the sole determinant of capital flows. The development of financial markets, and their appropriate supervision, is also a key factor. IMF research shows that `a more developed domestic financial sector both increases the volume and reduces the volatility of capital flows.'

Portfolio investment in sub-Saharan Africa, although increasing, remains limited, in

part, due to underdeveloped capital and financial markets. In particular:

- Only half of sub-Saharan African countries have established equity markets, and of these, only 9 markets have more than 20 listings.
- Also, fewer than half of all of sub-Saharan African countries have established debt markets and where such markets exist they generally lack depth and liquidity.

In addition, excluding South Africa, most of the sub-Saharan African countries that have established capital markets have weak trading, settlement and custodial systems. For foreign investors used to trading large blocks of securities almost instantaneously, the small size and weak infrastructure of sub-Saharan African capital markets are a clear obstacle to investment.

So how do we bring about greater capital market development? Capital markets do not grow in a vacuum. Rather, their development is built on the foundation of transparent, reliable regulatory systems that have credibility with investors. Countries should focus their reforms in key areas, including banking supervision, credit reporting and accounting systems.

Technical assistance for financial sector development is available. The Treasury Department has provided this assistance in several African countries, including Ghana, Kenya, Malawi, Nigeria, Rwanda, Tanzania, Uganda, and Zambia. We have seen promising signs of capital market development in these countries--a lengthening yield curve and greater liquidity--leading in turn to greater levels of investment.

3. Removing Obstacles to Foreign Investment in the Financial Sector

Finally, foreign investment flows to where it is welcome; it follows, therefore, that African countries can attract greater investment by removing legal and regulatory obstacles to investment flows.

Again, a number of sub-Saharan African countries have made notable progress in strengthening their investment climates. And, some of these countries have taken steps designed to make it easier for foreigners to participate in their capital markets. Greater financial openness helps to attract portfolio inflows. Ghana, Nigeria, Uganda, Kenya, Botswana, and Zambia – all countries with significantly liberalized capital accounts – have attracted the bulk of portfolio flows to sub-Saharan Africa outside of South Africa. Investment in the financial sector can be particularly important in supporting economic growth.

Against such progress, we are seeing new restrictions on foreign investment in the financial sector with increasing frequency – both in Africa and elsewhere. While African governments may impose this restriction to protect and develop local financial institutions, keeping foreigners from investing in the financial sector has a detrimental impact on financial sector development. Allowing foreign participation in the banking sector promotes financial system efficiency and transfers advanced banking practices, thereby increasing lending capacity, improving lending practices, and raising standards for loan management. By opening their financial sectors to foreign investment, African countries can leverage the expertise of global banks to deepen their financial markets.

Conclusion

Maintaining macroeconomic stability, developing local financial markets, and removing obstacles to foreign investment – we know that reforms in these areas are challenging and will take time. However, the benefits are substantial for African countries willing to undertake these reforms. Increasing the flow of private capital will boost investment in infrastructure and enhance productivity throughout the economy. Moreover, a better developed financial infrastructure will enhance the capacity of African countries to withstand the shocks that confront them today.

Just as important, reforms needed to attract foreign investors should be seen as part of the broader economic reform efforts undertaken in many sub-Saharan African countries today. Foreign investors will certainly benefit from these reforms, but the greatest impact is on the domestic economy. Removing obstacles to foreign

investment may appeal to foreign investors, but the real payoff is for African businesses that will gain access to the capital they need to finance their growth. Macroeconomic stability in Nigeria may comfort investors in New York or London, but the real beneficiaries of that country's low inflation and robust growth live in Lagos and Abuja.

That is the aim of these efforts and the issues I have discussed today – to develop the financial systems that assist Africa's people to achieve a prosperous, hopeful future. Thank you.

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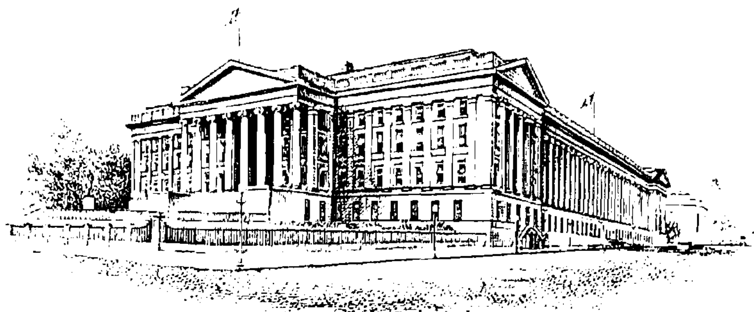

DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

July 16, 2008
EMBARGOED UNTIL 9:00 AM

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TREASURY INTERNATIONAL CAPITAL DATA FOR MAY

Treasury International Capital (TIC) data for May 2008 are released today and posted on the U.S. Treasury website (www.treas.gov/tic). The next release, which will report on data for June, is scheduled for August 15, 2008.

Net foreign purchases of long-term securities were $67.0 billion.

- Net foreign purchases of long-term U.S. securities were $92.4 billion. Of this, net purchases by private foreign investors were $75.7 billion, and net purchases by foreign official institutions were $16.7 billion.

- U.S. residents purchased a net $25.4 billion of long-term foreign securities.

Net foreign acquisition of long-term securities, taking into account adjustments, is estimated to have been $44.4 billion.

Foreign holdings of dollar-denominated short-term U.S. securities, including Treasury bills, and other custody liabilities increased $9.3 billion. Foreign holdings of Treasury bills increased $11.4 billion.

Banks' own net dollar-denominated liabilities to foreign residents declined $56.2 billion.

Monthly net TIC flows were negative $2.5 billion. Of this, net foreign private flows were negative $16.5 billion, and net foreign official flows were $14.0 billion.

TIC Monthly Reports on Cross-Border Financial Flows

(Billions of dollars, not seasonally adjusted)

		2006	2007	12 Months Through May-07	12 Months Through May-08	Feb-08	Mar-08	Apr-08	May-08
	Foreigners' Acquisitions of Long-term Securities								
1	Gross Purchases of Domestic U.S. Securities	21077.1	29730.6	23554.2	32902.6	2920.2	3075.9	2590.1	2505.9
2	Gross Sales of Domestic U.S. Securities	19933.9	28714.7	22295.2	32043.6	2847.2	2999.3	2488.6	2413.5
3	**Domestic Securities Purchased, net** (line 1 less line 2) /1	**1143.2**	**1015.9**	**1259.0**	**859.0**	**73.0**	**76.6**	**101.5**	**92.4**
4	**Private, net /2**	**946.6**	**828.2**	**1044.2**	**587.6**	**66.3**	**28.2**	**60.3**	**75.7**
5	Treasury Bonds & Notes, net	125.9	197.9	182.3	224.7	19.3	23.8	54.7	10.8
6	Gov't Agency Bonds, net	193.8	107.0	153.8	125.6	35.7	2.8	4.3	13.4
7	Corporate Bonds, net	482.2	342.8	534.2	172.5	14.9	-8.8	17.5	46.4
8	Equities, net	144.6	180.4	174.0	64.7	-3.7	10.4	-16.1	5.1
9	**Official, net /3**	**196.6**	**187.7**	**214.9**	**271.5**	**6.7**	**48.4**	**41.3**	**16.7**
10	Treasury Bonds & Notes, net	69.6	3.0	59.7	79.2	-3.6	28.0	22.3	-3.1
11	Gov't Agency Bonds, net	92.6	119.1	123.8	95.2	1.2	15.9	11.0	10.8
12	Corporate Bonds, net	28.6	50.6	33.2	61.8	4.4	4.1	7.5	9.0
13	Equities, net	5.8	15.1	-1.9	35.3	4.8	0.4	0.4	0.0
14	Gross Purchases of Foreign Securities from U.S. Residents	5515.9	8187.6	6406.0	8553.2	684.0	752.9	699.0	651.5
15	Gross Sales of Foreign Securities to U.S. Residents	5766.8	8411.9	6685.6	8699.1	694.9	752.9	688.6	676.9
16	**Foreign Securities Purchased, net** (line 14 less line 15) /4	**-250.9**	**-224.3**	**-279.5**	**-145.9**	**-10.9**	**-0.1**	**10.4**	**-25.4**
17	Foreign Bonds Purchased, net	-144.5	-129.0	-175.8	-63.1	7.3	2.9	10.7	-9.2
18	Foreign Equities Purchased, net	-106.5	-95.3	-103.8	-82.8	-18.3	-2.9	-0.3	-16.2
19	**Net Long-Term Securities Transactions** (line 3 plus line 16):	**892.3**	**791.6**	**979.5**	**713.1**	**62.1**	**76.6**	**111.9**	**67.0**
20	**Other Acquisitions of Long-term Securities, net /5**	**-174.6**	**-235.1**	**-203.9**	**-236.0**	**-18.3**	**-20.1**	**-12.3**	**-22.6**
21	**Net Foreign Acquisition of Long-Term Securities** (lines 19 and 20):	**717.7**	**556.5**	**775.6**	**477.1**	**43.7**	**56.4**	**99.7**	**44.4**
22	**Increase in Foreign Holdings of Dollar-denominated Short-term U.S. Securities and Other Custody Liabilities: /6**	**146.2**	**197.6**	**160.4**	**222.6**	**3.1**	**7.8**	**-14.0**	**9.3**
23	**U.S. Treasury Bills**	**-9.0**	**48.8**	**-10.9**	**123.9**	**14.6**	**27.9**	**3.4**	**11.4**
24	Private, net	16.1	29.3	11.3	77.8	17.4	30.9	-10.4	7.7
25	Official, net	-25.0	19.5	-22.2	46.1	-2.8	-3.0	13.8	3.7
26	**Other Negotiable Instruments and Selected Other Liabilities: /7**	**155.1**	**148.8**	**171.4**	**98.7**	**-11.6**	**-20.1**	**-17.4**	**-2.1**
27	Private, net	174.9	72.7	188.0	49.8	-6.0	-12.8	-4.4	10.2
28	Official, net	-19.8	76.1	-16.7	48.9	-5.6	-7.2	-13.0	-12.3
29	**Change in Banks' Own Net Dollar-Denominated Liabilities**	**198.0**	**-133.8**	**-86.3**	**-421.9**	**0.2**	**-115.4**	**-24.1**	**-56.2**
30	**Monthly Net TIC Flows** (lines 21,22,29) /8	**1061.8**	**620.4**	**849.7**	**277.9**	**47.0**	**-51.2**	**61.6**	**-2.5**
	of which								
31	Private, net	923.0	333.6	676.2	-35.5	56.5	-60.9	32.5	-16.5
32	Official, net	138.9	286.8	173.4	313.4	-9.5	9.7	29.1	14.0

/1 Net foreign purchases of U.S. securities (+)

/2 Includes international and regional organizations

/3 The reported division of net purchases of long-term securities between net purchases by foreign official institutions and net purchases of other foreign investors is subject to a "transaction bias" described in Frequently Asked Questions 7 and 10.a.4 on the TIC website.

/4 Net transactions in foreign securities by U.S. residents. Foreign purchases of foreign securities = U.S. sales of foreign securities to foreigners. Thus negative entries indicate net U.S. purchases of foreign securities, or an outflow of capital from the United States; positive entries indicate net U.S. sales of foreign securities.

/5 Minus estimated unrecorded principal repayments to foreigners on domestic corporate and agency asset-backed securities + estimated foreign acquisitions of U.S. equity through stock swaps - estimated U.S. acquisitions of foreign equity through stock swaps + increase in nonmarketable Treasury Bonds and Notes Issued to Official Institutions and Other Residents of Foreign Countries.

/6 These are primarily data on monthly changes in banks' and broker/dealers' custody liabilities. Data on custody claims are collected quarterly and published in the Treasury Bulletin and the TIC website.

/7 "Selected Other Liabilities" are primarily the foreign liabilities of U.S. customers that are managed by U.S. banks or broker/dealers.

/8 TIC data cover most components of international financial flows, but do not include data on direct investment flows, which are collected and published by the Department of Commerce's Bureau of Economic Analysis. In addition to the monthly data summarized here, the TIC collects quarterly data on some banking and nonbanking assets and liabilities. Frequently Asked Question 1 on the TIC website describes the scope of TIC data collection.

July 16, 2008
HP-1083

Statement by U.S. Treasury Secretary Henry M. Paulson, Jr.
On Industry Disclosure Initiative

Washington- *Treasury Secretary Henry M. Paulson, Jr., made the following statement today regarding the American Securitization Forum's Project RESTART, which includes improved issuer disclosure to investors and credit rating agencies, particularly on mortgage loan-level information:*

"With innovation in securitization and structured credit products has come varying degrees of complexity and other challenges, particularly related to securitization of mortgages. In March, the PWG determined that there was no single, simple solution to the problems that have emerged from the mortgage securitization process, yet market participants' behavior needed to change.

"Today's announcement by the American Securitization Forum is a meaningful commitment from market participants and is consistent with the March recommendations from the PWG. Improved disclosure is exactly what investors need to enhance their risk management practices and to give confidence to market participants. These types of actions should aid the return of the securitization market and help facilitate additional mortgage credit in the longer term."

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ASF LAUNCHES PROJECT RESTART ON JULY 16, 2008

ASF PROJECT RESTART

Overview of ASF Project RESTART

On July 16, the American Securitization Forum ("ASF") announced the public launch of ASF's Project on Residential Securitization Transparency and Reporting ("ASF Project RESTART" or "Project") to restore investor confidence in mortgage and asset-backed securities. Restoring this confidence and thereby restoring over time institutional investor capital to the securitization markets should ultimately increase the supply and lower the cost of mortgage and consumer credit in America. The Project has sought to identify areas of improvement in the process of securitization and refashion, in a comprehensive and integrated format, the critical aspects of securitization with market-based solutions and expectations. Each of the Project's phases has been sequenced to be developed and released for comment throughout the remainder of 2008 for implementation at specific recommended times in 2009. Although the initial focus of the Project has been on the private-label residential mortgage-backed securities ("RMBS") market, similar efforts are expected to be pursued in other major asset classes such as student loan, credit card and automobile securitizations.

In addition to announcing the broad direction of each of the phases of Project RESTART, the ASF has also released the first major deliverable of the Project—a request for comment ("RFC") on granular recommendations of an ASF RMBS Disclosure Package. Although principle-based topics of transparency, disclosure and diligence have played a critical role in the Project's discussions over the course of the past year, the request for comment on the ASF RMBS Disclosure Package included in this document reflects the Project's intense focus on developing specific and detailed market standards and practices that, through market-imposed incentives, will likely result in widespread implementation by applicable industry participants.

Development of the Project

Throughout the fall of 2007, a number of market participants began meeting in earnest under the auspices of the ASF to explore market challenges and identify areas of improvement, and started the process of developing specific market-based consensus solutions in those areas. In particular, there has been unprecedented industry attention on transparency and disclosure in mortgage-backed transactions and the processes, controls and procedures associated with these transactions. In February, 2008 at ASF's annual industry conference, a broad-based group of ASF members comprised of critical transaction parties came together to develop the core concepts and objectives of today's Project RESTART.

In March 2008, the ASF Board of Directors approved the creation of Project RESTART and its mission

statement to integrate and build upon the work which various working groups of the ASF had been engaged in since the fall of 2007. Subsequently, in its March 2008 Policy Statement on Financial Market Developments, the President's Working Group (PWG) on the Financial Markets, led by Treasury Secretary Paulson, recommended that the ASF develop templates for disclosure in securitization that support efforts to improve market discipline. The Project's objectives were further accelerated by and are directly responsive to the PWG's request. In a recent speech to investors on June 24, 2008, Acting Under Secretary for Domestic Finance Anthony W. Ryan announced that the President's Working Group had engaged the ASF as a private sector committee to develop best practices regarding disclosure to investors in securitized credits.

Comment Submission

Comments on the ASF RMBS Disclosure Package and the other documents included in the RFC are due by August 22, 2008. Additionally, as noted and provided in greater detail in the RFC, Project RESTART will also consist of additional phases comprised of an ASF RMBS Reporting Package, containing monthly data elements updated by servicers throughout the life of an RMBS transaction, as well as model representations and warranties, repurchase procedures, standards for pre-securitization due diligence, and model provisions for servicing and pooling agreements.

Get Involved

Several ASF task forces and working groups have played a key a role in the development of Project RESTART. ASF welcomes the participation of ASF members in Project RESTART, as well as associated ASF working groups and task forces working on different phases of the Project. Please contact Justin Ross, ASF Analyst, at [illegible] if you are interested in joining the ASF Repurchase Task Force, which has been examining certain issues relating to the administration and enforcement of repurchase obligations in MBS transactions, with the goal of developing and publishing a statement of recommended best practices to better inform market participants concerning this topic. Please contact Kathy Seid, ASF Analyst, at [illegible] if you are interested in joining the overall Project RESTART, the ASF RMBS Reporting Package Working Group, which is dedicated to the development of the project's RMBS Reporting Package, the ASF Representations and Warranties Working Group, or the ASF Due Diligence Working Group. Although participation in these groups is limited to ASF members, all industry members are able to submit comments on Project RESTART via the RFC.

Please contact Tom Deutsch, ASF Deputy Executive Director, at [illegible] with any questions or comments regarding Project RESTART.

Written Materials

Please find below links to key documents of ASF Project RESTART, including the RFC on the initial phase of the project which contains the data fields of the ASF RMBS Disclosure Package, transaction supplement fields, and the RMBS Disclosure Package Glossary, as well as documents and speeches of regulators and trade groups referencing this initiative.

- Project RESTART Request for Comment
- Statement of SEC Chairman Christopher Cox on Project RESTART
- Statement of U.S. Treasury Secretary Henry M. Paulson, Jr. on Project RESTART
- ASF Press Release on Project RESTART
- President's Working Group March 2008 Policy Statement
- Assistant Treasury Secretary Anthony Ryan's Remarks at Euromoney's Global Borrowers Investors Forum
- Acting Under Secretary Anthony Ryan's Remarks on Effective Capital Markets and Market Discipline
- Commercial Mortgage Securities Association's (CMSA) Press Release Regarding Project RESTART

Sunset Seminar on ASF Project RESTART

On July 16, 2008, the ASF hosted a Sunset Seminar entitled, "ASF Project RESTART: Industry-Led Plan to Restore Investor Confidence in Securitization." ASF members only are able to access the entire seminar online after the event, including an audio file and presentation materials, by clicking here.

2004-2008 American Securitization Forum

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March 13, 2008
hp-871

**President's Working Group Issues Policy Statement
To Improve Future State of Financial Markets**

Washington -The President's Working Group on Financial Markets issued a policy statement today with recommendations to improve the future state of U.S. and global financial markets. The statement offers the group's insight on causes of recent market issues and next steps for mitigating systemic risk, restoring investor confidence, and facilitating stable economic growth.

"The President's Working Group on Financial Markets has been reviewing policy issues to help reduce the likelihood that mistakes of the past are repeated. We have completed the assessment phase of our review, and are moving forward to focus on implementation," said Secretary Henry M. Paulson, Jr., chairman of the PWG, which includes the Treasury Department, the Federal Reserve, the Securities and Exchange Commission and the Commodity Futures Trading Commission. "I believe today's recommendations, when implemented, will strengthen market discipline, enhance risk management and improve the efficiency and stability of our capital markets."

"The recommendations set out in the Working Group's statement constitute an appropriate and effective response to the deficiencies in our financial framework that contributed to the current turmoil in financial markets. I strongly support them," said Federal Reserve Board Chairman Ben S. Bernanke.

SEC Chairman Christopher Cox said, "Several of the recommendations in today's Policy Statement fall within the purview of the SEC, including in particular those concerning the role of credit rating agencies. Congress has recently given the SEC new authority to address issues including conflicts of interest and the lack of competition in this industry-and we will use that authority to help restore investor confidence and healthy capital formation in our markets."

"These recommendations are a critical step in strengthening the US financial markets. The CFTC will continue to work with the other PWG members to implement the recommendations," said CFTC Acting Chairman Walt Lukken.

The PWG, working with the Office of the Comptroller of the Currency and the Federal Reserve Bank of New York, issued the statement to help enable market participants and regulators to better deal with the complexity that has resulted from market innovation. The recommendations offer steps to improve market transparency and disclosure, risk awareness and risk management, capital management and regulatory policies and market infrastructure for products such as over-the-counter derivatives. The statement focuses on changes needed from financial regulators and all market participants, including mortgage originators and brokers, financial institutions, issuers of securitized products, credit rating agencies and investors. The statement also discusses the challenges presented by securitization and over-the-counter derivatives.

"The OCC strongly supports the conclusions of the PWC policy statement and views it as an important step toward restoring stability in US markets," said Comptroller of the Currency John C. Dugan. "We are already pursuing implementation of its recommendations in the largest US banks that we supervise, and look forward to working with the other PWG participants on the wider reform agenda."

President Bush called on the PWG in August 2007 to review the underlying causes of the recent market issues. Members of the group have frequently discussed the

causes of the recent turmoil, including: lax underwriting standards for mortgages, particularly for subprime mortgages; an erosion of market discipline in the securitization process; flaws in credit rating agencies' assessments of some complex structured credit products; risk management weaknesses at global financial institutions; and regulatory policies that failed to mitigate risk management weaknesses.

The PWG will work with foreign regulators, finance ministries, and central banks through the international Financial Stability Forum and other venues to address these challenges globally.

The PWG is committed to progress toward implementation of the recommendations. Members will issue a progress statement in the fourth quarter of 2008 and consider whether further steps are needed to address weaknesses in financial markets, institutions and related supervisory policies.

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REPORTS

- Policy Statement of the President's Working Group on Financial Markets

Policy Statement on Financial Market Developments

The President's Working Group on Financial Markets

Department of the Treasury

Board of Governors of the Federal Reserve System

Securities and Exchange Commission

Commodity Futures Trading Commission

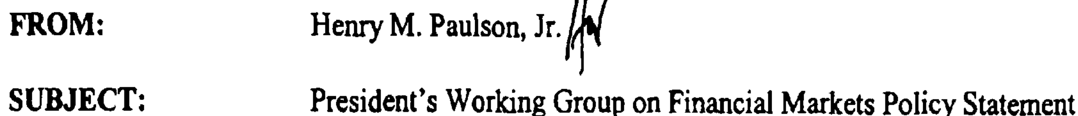
March 2008

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

March 13, 2008

MEMORANDUM FOR THE PRESIDENT



FROM: Henry M. Paulson, Jr.

SUBJECT: President's Working Group on Financial Markets Policy Statement

Last August, you called on the President's Working Group on Financial Markets (PWG) to review the underlying causes of developing financial market turmoil. I am pleased to transmit to you the policy statement of the PWG, which is led by me as the Secretary of the Treasury and includes the chairmen of the Federal Reserve Board, the Securities and Exchange Commission, and the Commodity Futures Trading Commission.

The PWG, working with the Office of the Comptroller of the Currency and the Federal Reserve Bank of New York, issued the statement to present the Group's findings on the causes of recent market turmoil and recommend changes to help avoid a repeat of recent events.

Obviously, market turmoil is still playing out, and all market participants and policy makers are deeply engaged in addressing the current situation. We must implement these recommendations with an eye toward not creating a burden that exacerbates today's market stresses.

We will monitor and report back to you on the implementation of these recommendations. In addition, we will make further recommendations later this year if we do not see the progress we are seeking.

Our objectives – which we believe these recommendations will achieve – are improved transparency and disclosure, better risk awareness and management, and stronger oversight. Collectively, these recommendations will mitigate systemic risk, help restore investor confidence, and facilitate economic growth.

Since mid-2007, financial markets have been in turmoil. Soaring delinquencies on U.S. subprime mortgages were the primary trigger of recent events. However, that initial shock both uncovered and exacerbated other weaknesses in the global financial system. Because financial markets are interconnected, both across asset classes and countries, the impact has been widespread. Global capital markets must function smoothly and effectively for economies to achieve sustainable growth. It is therefore in the interests of both policy makers and market participants to identify the causes of the market turmoil and to take the steps necessary to mitigate systemic risk, restore investor confidence, and facilitate stable economic growth.

The President's Working Group on Financial Markets (PWG) has undertaken a thorough analysis of the underlying factors contributing to the recent and on-going market stress. This analysis has been conducted to identify the weaknesses in global markets, institutions, and regulatory policies that triggered, amplified, or failed to mitigate the stress. On the basis of this analysis, the PWG has developed a comprehensive set of recommendations to address those weaknesses. This statement summarizes that analysis and sets out recommendations. It is comprised of three sections: a diagnosis and summary of recommendations; a review of factors contributing to the market turmoil; and a fuller discussion of policy issues and recommendations.

I. Diagnosis and Summary of Recommendations

Diagnosis

The global market turmoil has not yet abated, so any diagnosis is necessarily incomplete. Nonetheless, it seems clear from experience to date that the principal underlying causes of the turmoil in financial markets were:

- a breakdown in underwriting standards for subprime mortgages;
- a significant erosion of market discipline by those involved in the securitization process, including originators, underwriters, credit rating agencies, and global investors, related in part to failures to provide or obtain adequate risk disclosures;
- flaws in credit rating agencies' assessments of subprime residential mortgage-backed securities (RMBS) and other complex structured credit products, especially collateralized debt obligations (CDOs) that held RMBS and other asset-backed securities (CDOs of ABS);
- risk management weaknesses at some large U.S. and European financial institutions; and
- regulatory policies, including capital and disclosure[1] requirements, that failed to mitigate risk management weaknesses.

The turmoil in financial markets clearly was triggered by a *dramatic weakening of underwriting standards for U.S. subprime mortgages, beginning* in late 2004 and extending into early 2007. But the loosening of credit standards and terms in the subprime market was symptomatic of a much broader erosion of market discipline on the standards and terms of loans

[1] In this document disclosure requirements refer to the requirements of prudential regulators of financial institutions rather than to the Securities and Exchange Commission's (SEC) disclosure regulations and requirements applicable to U.S. public companies.

to households and businesses. Following many years of benign economic conditions and plentiful market liquidity, global investors had become quite complacent about risks, even in the case of new and increasingly complex financial instruments.

Competition and the desire to maintain higher returns created significant demand for structured credit products by investors. Originators, underwriters, asset managers, credit rating agencies, and investors failed to obtain sufficient information or to conduct comprehensive risk assessments on instruments that often were quite complex. Investors relied excessively on credit ratings, which contributed to their complacency about the risks they were assuming in pursuit of higher returns. *Although market participants had economic incentives to conduct due diligence and evaluate risk-adjusted returns, the steps they took were insufficient, resulting in a significant erosion of market discipline.*

Faulty assumptions underlying rating methodologies and the subsequent re-evaluations by the credit rating agencies (CRAs) led to a significant number of downgrades of subprime RMBS, even of recently issued securities. Downgrades were even more frequent and severe for CDOs of ABS with subprime mortgage loans as the underlying collateral. The number and severity of negative ratings actions caused investors to lose confidence in the accuracy of the ratings of a wide range of structured credit products. This loss of investor confidence caused many structured finance markets to seize up and caused markets for asset-backed commercial paper (ABCP), some of which was backed by RMBS and CDOs of ABS, to contract substantially.

These developments revealed *serious weaknesses in risk management practices at several large U.S. and European financial institutions*, especially with respect to the concentration of risks, the valuation of illiquid instruments, the pricing of contingent liquidity facilities, and the management of liquidity risk. Common themes were the failure of stress testing procedures to identify institutions' vulnerabilities to system-wide shocks to markets and market participants, and difficulties aggregating exposures across business lines and valuing instruments when markets became illiquid. These weaknesses were particularly evident with respect to the management of risks of holding CDOs of ABS, sponsoring or supporting off-balance sheet conduits that issued ABCP, and syndicating leveraged loans. As a result, some institutions suffered significant losses and many experienced significant balance sheet pressures. Balance sheet pressures contributed to a tightening of firms' lending standards and terms for a wide range of borrowers, which in turn has contributed to the slowing of U.S. economic growth.

In some cases, *regulatory policies failed to mitigate those risk management weaknesses*. For example, existing capital requirements encouraged the securitization of assets through facilities with very low capital requirements and failed to provide adequate incentives for firms to maintain capital and liquidity buffers sufficient to absorb extreme system-wide shocks without taking actions that tended to amplify shocks. Further, supervisory authorities did not insist on appropriate disclosures of firms' potential exposure to off-balance sheet vehicles.

Summary of Recommendations

The PWG has carefully reviewed the weaknesses in markets, institutions, and regulatory and supervisory practices that have contributed to financial turmoil and has developed recommendations to address those weaknesses. In developing its recommendations, the PWG has sought to avoid exacerbating the current strains on markets and institutions or risking unintended consequences. As noted above, the market turmoil has not yet abated. Thus, the PWG or its member agencies may put forward additional recommendations as events unfold and new insights are gained. Although no single measure can be expected to place financial markets on a sound footing, the PWG believes that implementation of its comprehensive and complementary set of recommendations would constitute an effective response to the identified weaknesses. In general, the recommendations include measures to be implemented by government authorities or market participants that will:

- reform key parts of the mortgage origination process in the United States;
- enhance disclosure and improve the practices of sponsors, underwriters, and investors with respect to securitized credits, thereby imposing more effective market discipline;
- reform the credit rating agencies' processes for and practices regarding rating structured credit products to ensure integrity and transparency;
- ensure that global financial institutions take appropriate steps to address the weaknesses in risk management and reporting practices that the market turmoil has exposed; and
- ensure that prudential regulatory policies applicable to banks and securities firms, including capital and disclosure requirements, provide strong incentives for effective risk management practices.

Recommendations for *reforming key parts of the mortgage origination process* include:

- All states should implement strong nationwide licensing standards for mortgage brokers;
- Federal and state regulators should strengthen and make consistent government oversight of entities that originate and fund mortgages and otherwise interface with customers in the mortgage origination process. All states should work towards adopting the principles set forth in the guidance developed by the federal regulators for nontraditional and subprime mortgage lending and ensure that effective enforcement mechanisms are in place to deal with noncompliance with such standards; and
- The Federal Reserve should issue stronger consumer protection rules and mandate enhanced consumer protection disclosures, including disclosures that would make affordability over the life of the mortgage more transparent and that would facilitate comparison of the terms with those of alternative products. State and federal authorities should coordinate to enforce the rules evenly across all types of mortgage originators.

Recommendations for *improving investors' contributions to market discipline* include:

- Overseers of institutional investors (for example, the Department of Labor for private pension funds; state treasurers for public pension funds; and the SEC for money market funds) should require investors (and their asset managers) to obtain from sponsors and underwriters of securitized credits access to better information about the risk characteristics of such credits, including information about the underlying asset pools, on an initial and ongoing basis;
- Overseers should ensure that these investors (and their asset managers) develop an independent view of the risk characteristics of the instruments in their portfolios, rather than rely solely on credit ratings; and
- The PWG will engage the private sector to create a committee to develop best practices regarding disclosure to investors in securitized credits, including ABS and CDOs of ABS.

Recommendations for *reforming the ratings processes for and practices regarding structured credit and other securitized credit products* include:

- Credit rating agencies should disclose what qualitative reviews they perform on originators of assets that collateralize ABS rated by the CRA and should require underwriters of ABS to represent the level and scope of due diligence performed on the underlying assets;
- The CRAs should reform their ratings processes for structured credit products to ensure integrity and transparency. The PWG welcomes the steps already taken by the CRAs, and particularly encourages the CRAs to:
    - enforce policies and procedures that manage conflicts of interest, including implementing changes suggested by the SEC's broad review of conflict of interest issues;
    - publish sufficient information about the assumptions underlying their credit rating methodologies, so that users of credit ratings can understand how a particular credit rating was determined;
    - make changes to the credit rating process that would clearly differentiate ratings for structured products from ratings for corporate and municipal securities;
    - make ratings performance measures for structured credit products and other ABS readily available to the public in a manner that facilitates comparisons across products and credit ratings;
    - work with investors to provide the information investors need to make informed decisions about risk, including measures of the uncertainty associated with ratings and of potential ratings volatility; and
    - ensure that adequate personnel and financial resources are allocated to monitoring and updating ratings.

  The PWG will facilitate formation of a private-sector group (with representatives of investors, issuers, underwriters, and CRAs) to develop recommendations for further steps that the issuers, underwriters, CRAs, and policymakers could take to

ensure the integrity and transparency of ratings, and to foster appropriate use of ratings in risk assessment;
- PWG member agencies will reinforce steps taken by the CRAs through revisions to supervisory policy and regulation, including regulatory capital requirements that use ratings; and
- The PWG will revisit the need for changes to CRA oversight if the reforms adopted by the CRAs are not sufficient to ensure the integrity and transparency of ratings.

Recommendations to *strengthen global financial institutions' risk management practices* include:

- Global financial institutions should promptly identify and address any weaknesses in risk management practices that the turmoil has revealed;
- The PWG will support formation of a private-sector group to reassess implementation of the Counterparty Risk Management Policy Group II's (CRMPG II) existing guiding principles and recommendations regarding risk management, risk monitoring, and transparency, and to modify or develop new principles and recommendations as necessary to incorporate lessons from the recent turmoil, including lessons regarding valuation practices;
- Supervisors of global financial institutions should closely monitor the firms' efforts to address risk management weaknesses, taking action if necessary to ensure that weaknesses are addressed;
- U.S. banking regulators and the SEC should promptly assess current guidance and develop common guidance to address the risk management weaknesses revealed by the recent market turmoil, including improvements to:
    - management information systems, including procedures that ensure aggregation of exposures across all business lines and ensure rigorous valuations of instruments and exposures;
    - concentration risk management, liquidity risk management, stress testing and other risk management practices that are necessary to ensure that liquidity and capital cushions are sufficiently robust to absorb extreme system-wide shocks; and
    - governance of the risk management and control framework, including the development of, and adherence to, practices that address incentive problems in compensation policies.
- U.S. authorities should encourage other supervisors of global firms to make complementary efforts to develop guidance along the same lines.

Recommendations to *enhance prudential regulatory policies* include:

- Regulators should adopt policies that provide incentives for financial institutions to hold capital and liquidity cushions commensurate with firm-wide exposure (both on and off-balance sheet) to severe adverse market events. These cushions should be forward looking and adjust appropriately through peaks and valleys of the credit cycle;

- Regulators should enhance guidance related to pipeline risk management for firms that use an originate-to-distribute model;
- The Basel Committee on Banking Supervision (BCBS) should promptly complete the work it has initiated to update the Committee's 2000 guidance on liquidity management, including the sound practice guidelines to be followed by regulated financial institutions as well as the oversight principles for supervisors.
- The BCBS and IOSCO should review capital requirements for ABS CDOs and other re-securitizations and for off-balance sheet commitments, with a view toward increasing requirements on exposures that have been the source of recent losses to firms;
- Regulators should require financial institutions to make more detailed and comprehensive disclosures of off-balance sheet commitments, including commitments to support ABCP conduits and other off-balance sheet vehicles;
- Regulators should encourage financial institutions to improve the quality of disclosures about fair value estimates for complex and other illiquid instruments, including descriptions of valuation methodologies and information regarding the degree of uncertainty associated with such estimates;
- Regulators should review the current use of ratings in regulation and supervisory rules. At a minimum, regulators should distinguish, as appropriate, between ratings of structured credit products and ratings of corporate and municipal bonds in regulatory and supervisory policies; and
- Authorities should encourage FASB to evaluate the role of accounting standards in the current market turmoil. This evaluation should include an assessment of the need for further modifications to accounting standards related to consolidation and securitization, with the goal of improving transparency and the operation of U.S. standards in the short-term. Additionally, authorities should encourage FASB and IASB to achieve more rapid convergence of accounting standards for consolidation of ABCP conduits and other off-balance sheet vehicles.

Additionally, while the infrastructure of the financial markets thus far has coped quite well with heightened price volatility and surging trading volumes, the PWG believes that the supervisors of OTC derivatives dealers, who have been working together under the leadership of the Federal Reserve Bank of New York, should insist on further enhancements to the infrastructure for the rapidly growing OTC derivatives markets.

Recommendations to *enhance the OTC derivative market infrastructure* include:

- Supervisors should insist that the industry promptly set ambitious standards for the accuracy and timeliness of trade data submission and the timeliness of resolutions of trade matching errors for OTC derivatives;
- Supervisors should urge the industry to amend standard credit derivative trade documentation to provide for cash settlement of obligations stemming from a credit event in accordance with the terms of the cash settlement protocol that has been developed but not yet incorporated into standard documentation; and
- Supervisors should ask the industry to develop a longer-term plan for an integrated operational infrastructure supporting OTC derivatives that:

- captures all significant processing events over the entire lifecycle of trades;
- delivers operational reliability and scalability;
- maximizes the efficiencies obtainable from automation and electronic processing platforms by promoting standardization and interoperability of infrastructure components;
- enhances participants' ability to manage counterparty risk through netting and collateral agreements by promoting portfolio reconciliation and accurate valuation of trades;
- addresses all major asset classes and product types; and
- encompasses the buy side as well as the dealer community.

II. Comprehensive Review of Contributing Factors

1. Underwriting standards for U.S. adjustable-rate subprime mortgages weakened dramatically between late 2004 and early 2007. As housing prices subsequently softened, the delinquency rate for such mortgages soared, exceeding 20 percent of the entire outstanding stock of adjustable-rate subprime mortgages in late 2007.[2]

2. Nearly all of these mortgages were packaged in residential mortgage-backed securities (RMBS) and a large share of the subprime RMBS were purchased by managers of CDOs of asset-backed securities (ABS), so-called ABS CDOs. The subprime RMBS and the ABS CDOs were structured in tranches and a very large share of the total value of the securities issued was rated AA or AAA by the credit rating agencies.

3. Both U.S. and international investors were eager purchasers of these securities. Indeed, the loosening of credit standards and terms in the subprime market was symptomatic of a broader erosion of market discipline on the standards and terms of loans to households and businesses. Following many years of benign economic and financial conditions, global investors had become quite complacent about risks, even in the case of new and increasingly complex financial instruments.

4. Many of the global investors in the AA and AAA tranches relied heavily on the ratings in making investment decisions or in communicating risk appetites to their investment managers, rather than undertaking their own independent credit analysis on instruments that often were quite complex. When it became apparent that even AAA tranches of some ABS CDOs could face large writedowns, investors lost faith in the ratings of complex structured products more broadly.

5. No longer willing to rely on ratings and unable to perform their own credit analyses, investors pulled back from a wide range of structured product markets. Issuance of all types of non-agency RMBS declined substantially. In addition, issuance of collateralized loan obligations (CLOs) became more difficult, at a time when a huge overhang of leveraged loan commitments ($225 billion in the U.S. alone) had already made investors reluctant to buy such loans at committed spreads and terms.

6. From 2004 to 2007, ABCP markets in the U.S. and abroad had grown very rapidly. Much of the growth was accounted for by conduits, including structured investment vehicles (SIVs) and CDOs, which purchased securities, including non-agency RMBS and CDOs, rather than by more traditional conduits that purchased short-term corporate and consumer receivables. As in the case of structured finance products, investors in ABCP, including money market funds, seem to have relied heavily on credit ratings rather than making their own assessments of the structure of these programs and the underlying collateral. As investors became aware that some of the underlying collateral was RMBS and CDOs, they pulled back from the ABCP market generally, and even, to some extent, from more traditional programs. In the United States alone, ABCP outstanding

[2] By contrast, the delinquency rate on the stock of outstanding fixed-rate subprime mortgages increased by only three percentage points over the same period, to around 8 percent.

declined by about one-third, or $370 billion, between early August 2007 and late December 2007. Since that time the amount of U.S. ABCP outstanding has changed little on balance.

7. The seizing up of structured credit markets and the contraction of ABCP markets imposed significant liquidity pressures on many of the largest U.S. and European financial institutions. These firms were the leading underwriters of non-agency RMBS and of ABS CDOs. When the structured credit markets shut down, the firms were left holding mortgages and RMBS that could not be sold off. Firms also were left holding exposures to leveraged loans that were in the process of being syndicated. Still more exposures were created when, in order to protect their reputations, some firms elected to purchase assets from, or extend credit to, off-balance sheet vehicles that they had organized and money market and other investment funds that they managed.

8. Many of these same firms were revealed to have concentrated exposures to subprime credit risk. While the business model of these firms with respect to subprime mortgages had been described as "originate to distribute," it gradually became apparent that some had retained significant credit exposures to the subprime market by retaining super-senior CDO tranches and by providing credit and liquidity enhancements to ABCP programs that invested in super-senior tranches of RMBS and CDOs. As a result, some firms suffered significant losses.

9. Firms themselves struggled to determine the size of these exposures and the resulting losses. As the structured credit markets seized up, reliable market-based price discovery became much more difficult for an increasing share of firms' portfolios; in many cases, models that were used for valuation in the absence of reliable market prices had not been adequately developed, or were not appropriate for the complex securities being evaluated. In addition, some firms had difficulty identifying and aggregating their exposures to subprime mortgage assets. As a result, they became concerned about the adequacy of their capital and the size of their balance sheets. They also became less confident of their assessments of the credit risk of other market participants that were known or suspected of holding such securities. In addition to concerns about counterparties' valuation practices, information about their holdings of such securities generally was not publicly available.

10. The combination of liquidity and balance sheet pressures and heightened credit concerns made banks reluctant to provide others with term funding. Term premiums embodied in LIBOR rates increased, at times to more than 100 basis points, and some other types of term funding became more difficult and costly. Traditional central bank liquidity tools were unable to bring term premiums in the interbank markets down. Changes to the primary credit program that the Federal Reserve announced in August 2007 – the narrowing of the spread of the primary credit rate relative to the target funds rate and increased scope to borrow at term – had little success, perhaps because they did not eliminate the stigma associated with borrowing from the central bank. Moreover, discount window facilities likely do not substantially reduce banks' concerns about balance sheet pressures or counterparty risk. With creditors skittish and banks' balance sheets increasing, conditions in term funding markets remained strained through year-end 2007.

11. More generally, uncertainty about asset valuations in illiquid markets and about financial institutions' exposures to asset price changes left investors and markets jittery. Of particular

concern were the exposures of financial guarantors to protection they had provided on super-senior CDO tranches. Downgrades of these institutions' credit ratings could disrupt financial markets in which investors rely heavily on their guarantees, notably the U.S. municipal bond market. In addition, failure of one of the guarantors would impose additional losses on financial institutions that had purchased CDO protection from the guarantor.

12. Prior to year-end 2007, a new tool, the Term Auction Facility (TAF), was deployed by the Federal Reserve. It appears not to have been hindered by concerns about stigma and appears to have helped reduce term premiums. However, it is uncertain how much of the reduction in term premiums just after year-end 2007 resulted from the availability of the TAF and how much was the result of relieved concern following year-end.

13. By early 2008, the financial disorder had not abated. Issuance of RMBS remained very weak, issuance of commercial mortgage-backed securities (CMBS) was off substantially from the first half of 2007, and CLO issuance was running well below its levels of spring 2007. Term premiums declined with the turn of the year but subsequently have widened, reportedly on renewed concerns about bank balance sheet pressures and heightened uncertainty about the economic outlook. More recently, liquidity in the agency RMBS market has deteriorated, yields on municipal bonds have risen substantially relative to those on comparable-maturity Treasuries, and issuance of municipal bonds has declined noticeably. Costs of residential mortgage and business credit were up significantly compared to the summer of 2007, and survey evidence pointed to tighter standards for a broad range of loans. In part, the higher costs and tighter standards appeared to reflect concerns about the effects of the contraction in the housing sector and the developments in financial markets on the broader economy.

14. Losses from hedge fund defaults through year-end 2007 were negligible, but preliminary data indicate that hedge fund performance was poor in January, and in the last few weeks, a growing number of hedge funds have missed margin calls. Counterparties continue to monitor their exposures to hedge funds closely.

15. The infrastructure of the financial markets generally has coped quite well with the heightened price volatility and surging trading volumes. Backlogs of unconfirmed trades in credit derivatives increased substantially in July and August 2007 but subsequently receded. Although liquidity in the credit derivatives markets has declined noticeably by some measures, those markets have continued to perform important price discovery and risk management functions.

III. *Policy Issues and Recommendations*

A. Reforming the Mortgage Origination Process

Issues

1. State-licensed mortgage brokers, who take loan applications and shop them to depository institutions or other lenders, had similarly weak incentives. Weak government oversight of these entities also contributed to the rise in unsound underwriting practices.

2. Originators had weak incentives to maintain strong underwriting standards, particularly at a time when securitizers, credit rating agencies, and mortgage investors did not conduct due diligence sufficient to align originator incentives with the underlying risks. Against this backdrop, limited government oversight of mortgage companies not affiliated with regulated depositories, which made about half of higher-priced mortgages in 2006, contributed to a rise in unsound underwriting practices in the subprime sector, including, in some cases, fraudulent and abusive practices.

3. Consumer protection rules and disclosure requirements did not sufficiently protect consumers against improper lending.

Recommendations to address issues

1. State financial regulators should implement strong nationwide licensing standards for mortgage brokers. As a first step, the CSBS and the American Association of Residential Mortgage Regulators (AARMR) have already created a nationwide licensing system and database for mortgage professionals; seven states began participating when the system was initially started, and dozens more committed to participate over time.

2. Federal and state regulators should strengthen and make consistent government oversight of all entities that originate and fund mortgages and otherwise interface with customers in the mortgage origination process. All states should work towards adopting the principles set forth in the guidance developed by the federal regulators for nontraditional and subprime mortgage lending and ensure that effective enforcement mechanisms are in place to deal with noncompliance with such standards. One key step that already has been taken is that the Conference of State Bank Supervisors (CSBS) issued principles-based underwriting guidance on subprime mortgages in July 2007 that was nearly identical to guidance issued earlier by federal supervisory agencies. In addition, a group of supervisors has launched a pilot program to review the underwriting standards and senior management oversight of risk management strategies for ensuring compliance with consumer protection laws and regulations at selected nondepository lenders with significant subprime mortgage operations.[3] The results of these reviews should be analyzed in order to determine whether to continue the project and, if so, how to focus future reviews.

[3] The Federal Reserve, the Office of Thrift Supervision, the Federal Trade Commission, the CSBS, and the American Association of Residential Mortgage Regulators (AARMR) are participating in the pilot program.

3. The Federal Reserve should issue stronger consumer protection rules and mandate enhanced consumer protection disclosures that would make affordability over the life of the mortgage more transparent and that would facilitate comparison of the terms with those of alternative products. To this end, the Federal Reserve is currently engaged in a review of the Truth in Lending Act (TILA) rules for mortgage loans, including consumer testing, and plans to propose new mortgage disclosures based on the results. The Federal Reserve has already proposed changes to the TILA rules to address concerns about incomplete or misleading mortgage loan advertisements and solicitations and to require lenders to provide mortgage disclosures more quickly. Those changes should be enacted once appropriate account has been taken of feedback received over the 90-day comment period. In December 2007, the Federal Reserve used its authority under the Home Ownership and Equity Protection Act (HOEPA) to propose new rules that address abuses related to prepayment penalties, failure to escrow for taxes and insurance, stated-income and low-documentation lending, and failure to give adequate consideration to borrowers' ability to repay. These rules should be enacted once appropriate account has been taken of feedback received over the 90-day comment period.

4. State and federal authorities should coordinate to enforce consumer protection and disclosure rules evenly across all types of mortgage originators.

5. Federal and state authorities should pursue mortgage market participants who engaged in fraudulent transactions and any parties undertaking fraudulent schemes to take advantage of households facing foreclosure.

B. *Improving Investors' Contributions to Market Discipline*

Issues

1. Investors and asset managers failed to obtain sufficient information or to conduct comprehensive risk assessments. For many investors, the use of credit ratings in risk management systems has fallen behind innovation in financial markets. In particular, many investors seem to treat a credit rating as a "sufficient statistic" for the full range of risks associated with an instrument, when, in fact, credit ratings are assessments of creditworthiness, and not of liquidity, market, or other risks. Some investors also relied exclusively on ratings for valuation purposes.

2. In turn, originators, underwriters, and sponsors did not always supply investors with sufficient information related to assets they were selling, securitizing, or using as collateral for structured credit products.

3. Separately, firms that sponsor ABCP programs or provide liquidity or credit enhancements to such programs disclose to their own shareholders and creditors considerably less information about the nature and composition of risk characteristics of the underlying assets than they would if the assets were on their own balance sheets.

4. Although market participants had economic incentives to conduct due diligence and evaluate risk-adjusted returns, the steps they took were insufficient, resulting in a significant erosion of market discipline.

Recommendations to address issues

1. Overseers of institutional investors (for example, the Department of Labor for private pension funds; state treasurers for public pension funds; and the SEC for money market funds) should require investors (and their asset managers) to obtain from sponsors and underwriters of securitized credits access to better information about the risk characteristics of such credits, including information about the underlying asset pools, on an initial and ongoing basis.

2. Overseers should ensure that these investors (and their asset managers) develop an independent view of the risk characteristics of the instruments in their portfolios, rather than rely solely on credit ratings.

3. To limit rating shopping, underwriters and sponsors of structured finance products should publicly disclose whether, after submitting final data and information about a proposed structure to one or more CRAs and receiving preliminary ratings from the CRA(s) based on the information, they choose to publish some but not all of the preliminary rating(s) as final ratings. The disclosure should include the reason for not having any such preliminary ratings published as final ratings.

4. To enable investors to improve their due diligence for structured finance products, underwriters and sponsors should provide improved disclosures for RMBS, ABS CDOs, and other structured products. Asset managers and financial institutions, including those running conduits, should provide improved disclosures.

5. Investors should take account of differences in risk between different classes of instruments, rather than relying on generic credit ratings when making investment decisions, communicating investment mandates to investment managers, and evaluating investment managers.

6. Where investors utilize investment consultants, they should insist that the consultants develop an independent view of the broad range of risk characteristics of the types of instruments in the investor's portfolio, rather than solely relying on the credit ratings.

7. Building on its existing templates for disclosures by multi-seller ABCP conduits, the American Securitization Forum (ASF) should develop templates for disclosures to investors for other types of securitizations. Supervisors should encourage banks and other regulated entities that sponsor ABCP conduits to make disclosures consistent with the templates.

8. The PWG will engage the private sector to create a committee to develop best practices regarding disclosure to investors in securitized credits, including ABS and CDOs of ABS.

9. Consistent with their disclosures of on-balance sheet risk, public companies that sponsor or provide credit or liquidity enhancements to ABCP programs should disclose the distribution of

assets underlying the programs by type, industry, and credit risk to the extent material to the company.

C. *Reforming the Ratings Agencies' Process for and Practices regarding Structured Credit and Other Securitized Credit Products*

Issues

1. Credit rating agencies contributed significantly to the recent market turmoil by underestimating the credit risk of subprime RMBS and other structured credit products, notably ABS CDOs.

2. With respect to subprime RMBS, in part the rating agencies underestimated the credit risk because they underestimated the severity and breadth of the softening in housing prices and the potential for fraud.

3. The rating agencies' models for rating ABS CDOs relied on assumptions about correlations between ABS that underestimated the degree of linkages between underlying securities.

4. As acknowledged by the rating agencies, structured products have quite different risk characteristics from corporate bonds. Nonetheless, they used the same rating categories for both types of instruments and many investors seem to have acted as if they did not understand or appreciate that the risk characteristics differed.

5. The methodologies that the rating agencies used to rate structured products are reasonably transparent. Nonetheless, greater transparency is both possible and desirable.

Recommendations to address issues

1. Credit rating agencies should disclose what qualitative reviews they perform on originators of assets that collateralize ABS rated by the CRA and should require underwriters of ABS to represent the level and scope of due diligence performed on the underlying assets.

2. The CRAs should reform their ratings processes for structured credit products to ensure integrity and transparency. The PWG welcomes the steps already taken by the CRAs, and particularly encourages the CRAs to: (a) enforce policies and procedures that manage conflicts of interest, including implementing changes suggested by the SEC's broad review of conflict of interest issues; (b) publish sufficient information about the assumptions underlying their credit rating methodologies and models, so that users of credit ratings can understand how a particular credit rating was determined; (c) make changes to the credit rating process that would clearly differentiate ratings for structured products from ratings for corporate and municipal securities; (d) make ratings performance measures for structured credit products and other ABS readily available to the public in a manner that facilitates comparison across products and credit ratings; (e) work with investors to provide the information investors need to make informed decisions about risk, including measures of the uncertainty associated with ratings and of potential ratings

volatility; and (f) ensure that adequate personnel and financial resources are allocated to monitoring and updating its ratings.

3. The rating agencies should be encouraged to conduct formal, periodic, internal reviews of criteria and methodologies for ratings of structured credit products.

4. The International Organization of Securities Commissions (IOSCO) should be encouraged to continue addressing credit rating issues through revisions to its "Code of Conduct."

5. The PWG will facilitate formation of a private-sector group (with representatives of investors, issuers, underwriters, and CRAs) to develop recommendations for further steps that the issuers, underwriters, CRAs, and policy makers could take to ensure the integrity and transparency of ratings, and to foster appropriate use of ratings in risk assessment.

6. The PWG member agencies will reinforce steps taken by the CRAs through revisions to supervisory policy and regulation, including regulatory capital requirements that use ratings.

7. The PWG will revisit the need for changes to CRA oversight if the reforms adopted by the CRAs are not sufficient to ensure the integrity and transparency of ratings.

D. Strengthening Global Financial Institutions' Risk Management Practices

Issues

1. The effectiveness of certain risk management practices was a key factor that differentiated institutions that sustained significant losses during the financial crisis from institutions that, while affected to some degree, avoided significant losses.

2. Firms that suffered significant losses tended to exhibit the following risk management weaknesses: (a) weak controls over potential balance sheet growth, including ineffective limits on the growth of business lines and poor monitoring of off-balance sheet exposures; (b) inadequate communications among senior management, business lines, and risk management functions; (c) dependence on a narrow range of risk measures that were based on assumptions that proved erroneous and on measurement processes that were difficult to alter once it became apparent that the underlying assumptions were wrong; and (d) insufficient attention to valuation issues, including excessive reliance on credit ratings and inadequate development of models for valuing complex or potentially illiquid securities.

3. These weaknesses were particularly evident with respect to the management of certain business lines: (a) CDO warehouses; (b) syndication of leveraged loans; and (c) conduit businesses (sponsorship or liquidity support for SIVs and other conduits that issued ABCP).

4. The root causes of valuation uncertainty were the failure of many financial institutions to develop sufficiently robust valuation models for complex, mortgage-related structured products and fundamental uncertainty about the ultimate performance of the underlying mortgage pools.

5. Losses from hedge fund defaults through year-end 2007 were negligible, but preliminary data indicate that hedge fund performance was poor in January, and in the last few weeks, a growing number of hedge funds have missed margin calls. Counterparties continue to monitor their exposures to hedge funds closely. Prior to the financial crisis, a multilateral review of major banks' and securities firms' counterparty risk management practices revealed some weaknesses with respect to the measurement of potential exposures and stress tests. In recent meetings with supervisors, financial institutions noted that some of those weaknesses remained.

Recommendations to address issues

1. Global financial institutions should promptly identify and address any weaknesses in risk management practices that the turmoil has revealed. These firms, and other financial institutions with similar types of weaknesses in their operations, should strongly reemphasize the importance of: (a) a strong, independent risk management function; (b) strategic planning with respect to balance sheet growth and utilization of capital and liquidity; (c) assessment of risks on an integrated basis across the enterprise; (d) ongoing communication among senior management, business lines, and risk management functions; and (e) the development of, and adherence to, strong operational and financial reporting controls over valuations.

2. The PWG will support formation of a private-sector group to reassess implementation of the Counterparty Risk Management Policy Group II's (CRMPG II) existing guiding principles and recommendations regarding risk management, risk monitoring, and transparency, and to modify or develop new principles and recommendations as necessary to incorporate lessons from the recent turmoil, including lessons regarding valuation practices.

3. Supervisors of global financial institutions should closely monitor the firms' efforts to address risk management weaknesses, taking action if necessary to ensure that weaknesses are addressed.

4. U.S. banking regulators and the SEC should promptly assess current guidance and develop common guidance to address the risk management weaknesses revealed by the recent market turmoil, including improvements to: (a) management information systems, including procedures that ensure aggregation of exposures across all business lines and ensure rigorous valuations of instruments and exposures; (b) concentration risk management, liquidity risk management, stress testing, and other risk management practices that are necessary to ensure that liquidity and capital cushions are sufficiently robust to absorb extreme system-wide shocks; and (c) governance of the risk management and control framework, including practices that address incentive problems in compensation policies.

5. U.S. authorities should encourage other supervisors of global firms to make complementary efforts to develop guidance along the same lines.

E. Enhancing Prudential Regulatory Policies

Issues

1. Various regulatory policies failed to mitigate some of the risk management weaknesses that have been identified.

2. Minimization of regulatory capital requirements by banks is an important driver of bank behavior. The limited risk sensitivity of Basel I encouraged banks to securitize low-risk assets and to support securitizations through facilities having low mandated capital charges. The securitization framework in Basel II is a more risk-sensitive approach that addresses many (but not all) of Basel I's shortcomings in that area. Existing capital requirements are not designed to address non-contractual exposures such as those arising from sponsorship of SIVs or mutual funds that firms may assume for reputational reasons.

3. Once firms experienced losses, their desire to maintain a capital buffer above regulatory levels significantly increased the risk that they would restrict credit availability and thereby add to stress in credit markets, with the potential for feedback on the real economy.

4. Authorities did not insist on appropriate reporting and disclosures of off-balance sheet vehicles.

Recommendations to address issues

1. Regulators should adopt policies that provide incentives for financial institutions to hold capital and liquidity cushions commensurate with firm-wide exposure (both on- and off-balance sheet) to severe adverse market events. These cushions should be forward looking and adjust appropriately through peaks and valleys of the credit cycle.

2. Regulators should enhance guidance related to pipeline risk management for firms that use an originate-to-distribute model.

3. Given the weak controls over balance sheet growth at some firms and the resulting liquidity pressures that those firms experienced, the Basel Committee on Banking Supervision (BCBS) should promptly complete its work to update the Committee's 2000 guidance on liquidity management, including the sound practice guidelines to be followed by regulated financial institutions as well as the oversight principles for supervisors.

4. The BCBS and IOSCO should review capital requirements for ABS CDOs and other resecuritizations and for off-balance sheet commitments, with a view toward increasing requirements on exposures that have been the source of recent losses to firms. In particular, they should reconsider the relationship between external credit ratings and capital charges under the "ratings based approach," especially for ABS CDOs and other securitizations of ABS, as well as

the relationship between external ratings and capital charges under the "internal assessment approach" for exposures to ABCP programs.[4]

5. Supervisors should review the adequacy of guidance on Basel II's Pillar 2 with respect to the consideration of the reputational risks that conduit and asset management businesses entail and the implications for institutions' need for economic capital and their liquidity contingency plans.

6. To promote the maintenance of strong capital cushions and to mitigate the possibility that a more risk-based capital regime will heighten the potential for capital requirements to amplify credit and economic cycles, supervisors should rigorously assess banks' implementation of the Advanced Internal Ratings Based Approach to Basel II, especially the conservatism of estimates of losses from defaults during a downturn and the robustness of banks' stress tests.

7. Regulators should require financial institutions to improve their internal reporting and make more detailed and comprehensive disclosures of off-balance sheet commitments, including commitments to support ABCP conduits and other off-balance sheet vehicles.

8. Regulators should encourage financial institutions to improve the quality of disclosures about fair value estimates for complex and other illiquid instruments, including descriptions of valuation methodologies and information regarding the degree of uncertainty associated with such estimates.

9. State insurance commissioners should review the appropriateness of capital requirements for financial guarantors in light of changes in the firms' business lines. Financial guarantors should strengthen their models for assessing the risks of new activities.

10. Regulators should review the current use of ratings in regulatory and supervisory rules. At a minimum, regulators should distinguish, as appropriate, between ratings of structured credit products and ratings of corporate and municipal bonds in regulatory and supervisory policies.

11. Authorities should encourage FASB to evaluate the role of accounting standards in the current market turmoil. This evaluation should include an assessment of the need for further modifications to accounting standards related to consolidation and securitization, with the goal of improving transparency and the operation of U.S. standards in the short-term. Additionally, authorities should encourage FASB and IASB to achieve more rapid convergence of accounting standards for consolidation of ABCP conduits and other off-balance sheet vehicles.

F. Enhancements to the Infrastructure for OTC Derivatives Markets

Issues

1. While the infrastructure of the financial markets generally has coped quite well with heightened price volatility and surging trading volumes, there have been issues with the accuracy and timeliness of trade data submission; the timeliness of resolutions of trade matching errors;

[4] In the internal assessment approach the bank assigns an internal rating to the exposure and then maps the rating to an equivalent external rating.

documentation and cash settlement; electronic post-trade processing; backlogs; integrated processing, and reconciliation and valuation.

2. Although the industry has made significant progress in automating the infrastructure of the OTC derivatives markets over the last two years, the industry has not achieved a "steady state" in which events do not increase operational problems. This was evident in July and August 2007 when a spike in credit derivatives trades resulted in substantial increases in backlogs of unconfirmed trades throughout the industry.

3. Although the industry has developed a "cash settlement protocol" that can obviate the need for purchasers of credit protection to physically deliver obligations of the reference entity following a default or other credit event, standard industry trade documentation still requires physical settlement. Until the protocol is incorporated into standard industry documentation, there is a risk of significant market disruption if one or more major market participants chose not to adopt the protocol following a credit event. Of particular concern is the market impact such choices could have if multiple credit events were to occur simultaneously.

Recommendations to address issues

1. Supervisors should insist that the industry promptly set ambitious standards for the accuracy and timeliness of trade data submission and the timeliness of resolutions of trade matching errors for OTC derivatives.

2. Supervisors should urge the industry to promptly amend standard credit derivative trade documentation to provide for cash settlement of obligations stemming from a credit event, in accordance with the terms of the cash settlement protocol that has been developed but not yet incorporated into standard documentation.

3. Supervisors should ask the industry to develop a longer-term plan for an integrated operational infrastructure supporting OTC derivatives that: (a) captures all significant processing events over the entire lifecycle of trades; (b) delivers operational reliability and scalability; (c) maximizes the efficiencies obtainable from automation and electronic processing platforms by promoting standardization and interoperability of infrastructure components; (d) enhances participants' ability to manage counterparty risk through netting and collateral agreements by promoting portfolio reconciliation and accurate valuation of trades; (e) addresses all major asset classes and products types; and (f) encompasses the buy side as well as the dealer community.

Conclusion

Market participants have begun taking steps to address many of the weaknesses that have contributed to the turmoil in global financial markets. Nonetheless, policy makers need to monitor their efforts closely and reinforce them where necessary. In most cases policy makers' efforts to promote implementation of these recommendations will require domestic or international regulatory cooperation. The PWG will work to ensure that U.S. federal regulators cooperate effectively with each other and with the relevant state authorities. Internationally, the

PWG is working with foreign regulators, finance ministries, and central banks through the Financial Stability Forum (FSF) on a report to the G-7 Finance Ministers and Governors that will provide a diagnosis of the causes of global financial turmoil and an agreed-upon set of recommendations for addressing identified weaknesses in global markets and institutions. As part of that cooperative process, the PWG has shared with the FSF the diagnosis and recommendations set out in this statement.

The PWG plans to issue a follow-up statement in the fourth quarter of 2008 that will assess progress toward implementation of its recommendations and the FSF's recommendations and consider whether further steps are needed to address weaknesses in financial markets and institutions and related regulatory policies.

July 17, 2008
HP-1084

Under Secretary for International Affairs
David H. McCormick
Statement on Introduction of Clean Technology Fund Legislation

"The Treasury Department welcomes the Senate Foreign Relations Committee's introduction yesterday of bipartisan legislation authorizing $2 billion for international clean technology deployment, which would play an immediate role in reducing greenhouse gas emissions growth in the fastest growing developing countries. Secretary Paulson thanks Senators Biden, Lugar, Menendez, and Hagel for this important legislation, which supports the Administration's request for authorization of $2 billion in U.S. contributions to a new multilateral clean technology fund to combat the urgent challenge of global climate change. The Treasury Department looks forward to working with the authors to ensure the timely passage of effective legislation."

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July 17, 2008
HP-1085

Treasury Targets Al Qaida-Affiliated Terror Group in Algeria

Washington, DC--The U.S. Department of the Treasury today designated four leaders of al Qaida in the Lands of the Islamic Maghreb (AQIM), a terrorist organization that has carried out numerous attacks in Algeria. On July 3, 2008, these four individuals were added to the United Nations Consolidated List of individuals and entities associated with Usama Bin Laden, al Qaida, and the Taliban.

"Algeria has shown remarkable courage in the face of horrifying terrorist attacks against its people," said Adam J. Szubin, Director of the Office of Foreign Assets Control (OFAC). "The four terrorists that we have targeted today are among the most culpable for this violence, as leaders of al Qaida in the Lands of the Islamic Maghreb. We are proud to support the efforts of Algeria and the world community to combat this deadly threat and we will continue to do so."

AQIM carried out three attacks east of Algiers in early June 2008, including a bombing near a train station that killed a French national. In February 2008, AQIM kidnapped two Austrian tourists in Tunisia and has issued demands to the Austrian government for their release. In April 2007, AQIM bombed both the Algerian prime minister's office and police facilities in Algiers. AQIM conducted dual bombings in December 2007 of two United Nations offices and the headquarters of Algeria's Constitutional Council.

AQIM, which was formerly known as the Salafist Group for Preaching and Combat (GSPC), merged with al Qaida in September 2006. GSPC was one of the sixteen entities originally named a Specially Designated Global Terrorist (SDGT) pursuant to E.O. 13224 on September 24, 2001. GSPC was added to the U.N. list on October 6, 2001. AQIM was designated pursuant to E.O. 13224 on February 21, 2008 and was added to the U.N. list on April 26, 2007.

Identifier Information

SALAH GASMI

AKAs:
Salah Abu Muhamad
Salah Abu Mohamed
Bounouadher

DOB:
13 April 1971
POB:
Zeribet El Oued, Biskra, Algeria

Gasmi is the head of AQIM's information committee and is responsible for developing statements, circulating claims of responsibility for terrorist activities, and creating videos for AQIM.

As AQIM's representative to the media, Gasmi issued AQIM's claim of responsibility for its kidnapping of the Austrian hostages. Gasmi is one of the principal figures negotiating with the Austrian government for the release of the hostages. He represents AQIM leader Abdelmalek Droukdel's interests in the negotiations. Droukdel was added to the U.N. list on August 27, 2007 and was named an SDGT by the Treasury Department on December 4, 2007.

Gasmi also directs AQIM's internet communications with al Qaida senior

leadership.

YAHIA DJOUADI

AKAs:
Yahia Abu Amar
Abu Ala
Abou Alam

DOB:
1 January 1967
POB:
M'Hamid, Sidi Bel Abbas, Algeria

Djouadi is based in northern Mali and serves as the leader of AQIM in Africa's Sahara-Sahel region (also known as the AQIM South Zone). He is responsible for managing AQIM members in the South Zone and was actively recruiting Mauritanians as of early 2008.

Djouadi provided financial and operational support to a Moroccan AQIM-affiliated extremist who planned to establish an AQIM support base in North Africa.

Djouadi headed the AQIM military committee prior to his appointment as AQIM South Zone Emir.

AHMED DEGHDEGH

AKAs:
Abd Al Illah
Abu Abdallah

DOB:
17 January 1967
POB:
Anser, Jijel, Algeria

Deghdegh is AQIM's finance chief.

Deghdegh has relayed AQIM messages in ongoing hostage negotiations; as AQIM's designated negotiator, Deghdegh communicated stipulations for the release of the hostages and issued ransom demands.

Deghdegh has acknowledged that AQIM has worked to undermine the interests of countries that support U.S. counterterrorism efforts.

ABID HAMMADOU

AKAs:
Abid Hamadu
Abdelhamid Abu Zeid
Abdelhamid Abou Zeid
Youcef Adel
Abu Abdellah

DOB:
12 December 1965
POB:
Touggourt, Ouargla, Algeria

Hammadou is the deputy leader of AQIM's Tarek Ibn Zaid battalion and is based in northern Mali.

Hammadou was involved in kidnapping the Austrian tourists for AQIM in February 2008.

In 2003, Hammadou participated in the kidnapping of 32 foreign tourists in Algeria by the GSPC, AQIM's predecessor organization. Hammadou was appointed by regional AQIM leader al-Para to lead the Tarek Ibn Zaid battalion, which carried out the kidnapping (El Para, AKA Saifi Ammari, was named an SDGT on December 5, 2003). Hammadou and other members of the battalion received part of the ransom paid to liberate the tourists and allegedly used the funds to purchase weapons.

In June 2005, Hammadou led a unit of AQIM operatives in an attack on a Mauritanian military outpost that killed fifteen soldiers and wounded at least another fifteen.

Hammadou established a camp for AQIM recruits in northern Mali that included training in combat techniques, making and defusing bombs, and guerilla tactics.

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PRESS ROOM

July 17, 2008
2008-7-17-12-16-47-1692

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $75,855 million as of the end of that week, compared to $75,266 million as of the end of the prior week.

I. Official reserve assets and other foreign currency assets (approximate market value, in US millions)

	July 11, 2008		
A. Official reserve assets (in US millions unless otherwise specified) [1]	Euro	Yen	Total
(1) Foreign currency reserves (in convertible foreign currencies)			75,855
(a) Securities	10,213	12,075	22,288
of which: issuer headquartered in reporting country but located abroad			0
(b) total currency and deposits with:			
(i) other national central banks, BIS and IMF	14,612	5,944	20,556
ii) banks headquartered in the reporting country			0
of which: located abroad			0
(iii) banks headquartered outside the reporting country			0
of which: located in the reporting country			0
(2) IMF reserve position [2]	5,142		
(3) SDRs [2]	9,830		
(4) gold (including gold deposits and, if appropriate, gold swapped) [3]	11,041		
--volume in millions of fine troy ounces	261.499		
(5) other reserve assets (specify)	6,998		
--financial derivatives			
--loans to nonbank nonresidents			
--other (foreign currency assets invested through reverse repurchase agreements)	6,998		
B. Other foreign currency assets (specify)			
--securities not included in official reserve assets			
--deposits not included in official reserve assets			
--loans not included in official reserve assets			
--financial derivatives not included in official reserve assets			
--gold not included in official reserve assets			
--other			

II. Predetermined short-term net drains on foreign currency assets (nominal value)

			Maturity breakdown (residual maturity)		
		Total	Up to 1 month	More than 1 and up to 3 months	More than 3 months and up to 1 year
1. Foreign currency loans, securities, and deposits					
--outflows (-)	Principal				
	Interest				
--inflows (+)	Principal				
	Interest				
2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the domestic currency (including the forward leg of currency swaps)					
(a) Short positions (-) [4]		-62,000	-62,000		
(b) Long positions (+)					
3. Other (specify)					
--outflows related to repos (-)					
--inflows related to reverse repos (+)					
--trade credit (-)					
--trade credit (+)					
--other accounts payable (-)					
--other accounts receivable (+)					

III. Contingent short-term net drains on foreign currency assets (nominal value)

		Maturity breakdown (residual maturity, where applicable)		
	Total	Up to 1 month	More than 1 and up to 3 months	More than 3 months and up to 1 year
1. Contingent liabilities in foreign currency				
(a) Collateral guarantees on debt falling due within 1 year				
(b) Other contingent liabilities				
2. Foreign currency securities issued with embedded options (puttable bonds)				
3. Undrawn, unconditional credit lines provided by:				
(a) other national monetary authorities, BIS, IMF, and other international organizations				
--other national monetary authorities (+)				
--BIS (+)				
--IMF (+)				
(b) with banks and other financial institutions headquartered in the reporting country (+)				
(c) with banks and other financial institutions headquartered outside the reporting country (+)				
Undrawn, unconditional credit lines provided to:				
(a) other national monetary authorities, BIS, IMF, and other international organizations				
--other national monetary authorities (-)				

--BIS (-)				
--IMF (-)				
(b) banks and other financial institutions headquartered in reporting country (-)				
(c) banks and other financial institutions headquartered outside the reporting country (-)				
4. Aggregate short and long positions of options in foreign currencies vis-à-vis the domestic currency				
(a) Short positions				
(i) Bought puts				
(ii) Written calls				
(b) Long positions				
(i) Bought calls				
(ii) Written puts				
PRO MEMORIA: In-the-money options [11]				
(1) At current exchange rate				
(a) Short position				
(b) Long position				
(2) + 5 % (depreciation of 5%)				
(a) Short position				
(b) Long position				
(3) - 5 % (appreciation of 5%)				
(a) Short position				
(b) Long position				
(4) +10 % (depreciation of 10%)				
(a) Short position				
(b) Long position				
(5) - 10 % (appreciation of 10%)				
(a) Short position				
(b) Long position				
(6) Other (specify)				
(a) Short position				
(b) Long position				

IV. Memo items

(1) To be reported with standard periodicity and timeliness:	
(a) short-term domestic currency debt indexed to the exchange rate	
(b) financial instruments denominated in foreign currency and settled by other means (e.g., in domestic currency)	
--nondeliverable forwards	
--short positions	
--long positions	
--other instruments	
(c) pledged assets	
--included in reserve assets	
--included in other foreign currency assets	
(d) securities lent and on repo	7,168

--lent or repoed and included in Section I	
--lent or repoed but not included in Section I	
--borrowed or acquired and included in Section I	
--borrowed or acquired but not included in Section I	7,168
(e) financial derivative assets (net, marked to market)	
--forwards	
--futures	
--swaps	
--options	
--other	
(f) derivatives (forward, futures, or options contracts) that have a residual maturity greater than one year, which are subject to margin calls.	
--aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the domestic currency (including the forward leg of currency swaps)	
(a) short positions (–)	
(b) long positions (+)	
--aggregate short and long positions of options in foreign currencies vis-à-vis the domestic currency	
(a) short positions	
(i) bought puts	
(ii) written calls	
(b) long positions	
(i) bought calls	
(ii) written puts	
(2) To be disclosed less frequently:	
(a) currency composition of reserves (by groups of currencies)	75,855
--currencies in SDR basket	75,855
--currencies not in SDR basket	
--by individual currencies (optional)	

Notes:

1/ Includes holdings of the Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve's System Open Market Account (SOMA), valued at current market exchange rates. Foreign currency holdings listed as securities reflect marked-to-market values, and deposits reflect carrying values.

2/ The items, "2. IMF Reserve Position" and "3. Special Drawing Rights (SDRs)," are based on data provided by the IMF and are valued in dollar terms at the official SDR/dollar exchange rate for the reporting date. The entries for the latest week reflect any necessary adjustments, including revaluation, by the U.S. Treasury to IMF data for the prior month end.

3/ Gold stock is valued monthly at $42.2222 per fine troy ounce.

4/ The short positions reflect foreign exchange acquired under reciprocal currency arrangements with certain foreign central banks. The foreign exchange acquired is not included in Section I, "official reserve assets and other foreign currency assets," of the template for reporting international reserves. However, it is included in the broader balance of payments presentation as "U.S. Government assets, other than official reserve assets/U.S. foreign currency holdings and U.S. short-term assets."

July 17, 2008
HP-1086

U.S. Executive Director to the European Bank for Reconstruction and Development Nominee Kenneth L. Peel Testimony Before Senate Committee on Foreign Relations

Washington - Chairman Menendez, Senator Lugar, and Members of the Committee, I am grateful to the President for my nomination to be U.S. Executive Director to the European Bank for Reconstruction and Development, and I am deeply honored to appear before the Senate Foreign Relations Committee to discuss my qualifications for this position.

Being here today, I feel that I have come home. Since July 2001, I have served in a series of foreign and economic policy positions in the Administration. For six years before that, I served two Senators on this Committee: Senator Hagel, when he chaired the International Economic Policy Subcommittee, and Senator Snowe during her first two years in the Senate when she chaired the International Operations Subcommittee.

The great bulk of my professional career has been working on foreign policy and international economic policy in Congress, with a special focus on multilateral diplomacy. Before working in the Senate, I spent 12 years in the House, ten of those as professional staff on the House Foreign Affairs Committee.

Since July, 2001 I have held three positions in the Executive Branch. I served:

- as a Member of Secretary of State Colin Powell's Policy Planning Staff working on international organization and Eurasian issues,
- as an NSC Director covering international environment and energy issues, and
- as Deputy Assistant Secretary for International Development Finance and Debt at the Treasury Department.

In short, I believe that I am well equipped both by my academic and professional background to take on the position for which I have been nominated. My current position prepares me particularly well. As Treasury Deputy Assistant Secretary, I oversee U.S. policy towards all of the major multilateral development banks such as the World Bank and the regional development banks, including the European Bank for Reconstruction and Development.

Even though this nomination is coming late in the Administration, there are huge issues currently at the EBRD that will affect our interests in both the institution and in the region over the next six months. As you know, U.S. Executive Directors at the multilateral development banks are essentially our Ambassadors to those institutions. Since I work day in and day out on MDB policy, I see how important is to have strong Senate-confirmed Directors in place.

If confirmed by the U.S. Senate, I look forward to bringing my skills and background to advancing U.S. interests at the EBRD. I believe in our sometimes complicated system of government. Our co-equal, separate branches of government give us a unique strength when we work together, genuinely consult on policy directions, and speak with one voice. If confirmed, I look forward to being available to speak or meet with you or your staff at any time, and hope you won't mind if I seek out your advice at critical junctures in several of the key issues facing U.S. interests at the EBRD in the months ahead.

Mr. Chairman, Senator Lugar, Members of the Committee, I am grateful for the opportunity to appear before you today. I would be pleased to answer any of your questions.

July 17, 2008
HP1087

U.S. Executive Director for the African Development Bank Nominee
Mimi Alemayehou
Testimony Before Senate Committee on Foreign Relations

Washington - Chairman Menendez, Senator Lugar, and Members of the Committee, I am grateful for the opportunity to appear before you today. I am honored that President Bush has nominated me to serve as the U.S. Executive Director for the African Development Bank.

After his recent visit to Africa, the President commented: *"things have changed in Africa since my first visit, I mean striking changes;"* and then he continued: *"We're treating African leaders as equal partners. We expect them to produce measurable results. We expect them to fight corruption, and invest in the health and education of their people, and pursue market-based economic policies."*

I share the President's vision of a 'partnership of equals' between the United States and Africa. It is through such respectful and engaged partnership that Africans can play a driving role in Africa's development and African leaders can be accountable for their actions. If confirmed, I pledge to work with this Committee, Congress, and the Administration in furthering U.S. International Policy and Development goals. Increasingly, America's prosperity is becoming linked to peace and the raising of living standards for all individuals in the developing world. The African Development Bank is one of the most important regional development bank as it serves the world's least developed continent. The Bank's activities have a very high impact on the region and therefore command the focused attention of Africa's leadership.

Throughout most of my life, I made personal and professional choices which prepared me for a focused and challenging role – to serve as a bridge, an enabler, between our country of opportunity, and the continent of Africa, with its tremendous yet far from realized potential. I am grateful for the educational and professional opportunities the United States has afforded me. This, I believe prepared me for a role in the development of Africa and the international private sector as early as my days serving as an aide on Capitol Hill. Africa and the private sector re-emerged later in my work in international telecoms focusing on the introduction of a new technology to African countries, and more recently as an entrepreneur supporting the efforts of the United States-sponsored Africa Growth and Opportunity Act. I started TradeLinks in order to assist AGOA eligible member countries in the regional grouping of the Common Market for Eastern and Southern Africa (COMESA) so that they may increase their exports to the U.S. While I enjoyed working with the African governments and U.S. officials, I took the most pleasure from working with African entrepreneurs with great skills and products but were in desperate need of basic tools. They were in need of training or adequate equipment so that they can produce consistently high quality goods on a meaningful scale and in a tight timeframe.

Today's Africa is a far cry from my early years in Ethiopia under a communist regime that left an indelible mark on me. Entrepreneurship and democracy are now the order of the day; but the African private sector cannot thrive without a significant upgrade of the continent's infrastructure and financial systems. These challenges call for a strong and active African Development Bank to finally help turn Africa's long held promise into a reality. This optimism does, however, bring increased expectations with respect to governance, transparency, regional integration, and the need to develop African skills. That is the reason why Africa needs reliable partners such as the United States and strong institutions such as the African Development Bank. America's style of government and its liberalized economic model put us in an exceptional position to help steer the Bank towards the right policies and usher an unprecedented era of sustainable economic growth in Africa. The implementation of U.S. policy towards Africa, as well as our role on the Board of the African Development Bank, together constitute key tools to help Africa

achieve this growth. It would therefore be a privilege to work with Secretary Paulson, the Treasury Department, and Congress to increase the African Development Bank's impact and effectiveness.

While humbled by the nomination, I am excited about the prospects and challenges facing the African continent. I do hope to have the opportunity to play a role in getting the United States and the African Development Bank to work more closely together in order to help improve the lives and dignity of all 940 million Africans.

Mr. Chairman, Senator Lugar, Members of the Committee, thank you for considering my nomination. I would be pleased to answer any questions.

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July 17, 2008
HP-1088

U.S. Executive Director of the Inter-American Development Bank Nominee
Miguel R. San Juan
Testimony Before Senate Committee on Foreign Relations

Washington - Chairman Menendez, Senator Lugar, Members of the Committee, thank you for the opportunity to appear before you today. I am honored that President Bush has nominated me to serve as the United States Executive Director of the Inter-American Development Bank. I am grateful to have the support of the President and Secretary Paulson and the privilege of your consideration.

I would like to introduce members of my family sitting in the audience, my wife Lucia, and my sons Migue, Marcus and Maximo. My family continues to support me, as a full partner in my quest for public service.

I have long held aspirations of working in the public sector, especially in a capacity dealing with the Americas. Further, I believe strongly in the Inter-American Development Bank's mission. I look forward to having this opportunity to state my objectives as a candidate for the position, as well as to answering any questions regarding my experience and qualifications.

By the good graces of many, my family and I reunited in Houston, Texas after many years of separation following our departure from Cuba. I feel extremely fortunate that my career in economic development has given me an opportunity to give back to the country that welcomed us with open arms so many years ago. I am very eager to apply the lessons I learned at one of the nation's premier chamber organizations in service to the United States and another region dear to my heart, Latin America and the Caribbean.

Vicious cycles of poverty and crime pose an ongoing threat to the region's vast potential. The words of Nobel Laureate Octavio Paz come to mind: "América no es tanto una tradición que continuar, como un futuro que realizar." America is not so much a tradition to continue, as a future to realize. If Latin America is to realize the future it deserves, it must overcome these longstanding obstacles. There are, however, signs of hope and progress everywhere.

I believe the IDB plays a critical role in accelerating economic and social development in the region. In so doing, it also fosters hemispheric and global security. And at a critical point in the hemisphere's history, the IDB constitutes a force that can hold the region together, while others threaten to tear it apart.

Another area on which I hope to focus is the development of small to medium size industries in the region. President Bush has stated the relevance of SMEs to the health of this nation's economy. The same logic applies to the whole of the Americas. Today's SME's are tomorrow's multinationals. They are the seeds that create jobs and economic prosperity. To stimulate their growth in the region, I advocate increased cooperation and coordination between the IDB and Chambers of Commerce throughout Latin America and the Caribbean.

Above all, I view the principal role of the IDB Executive Director as representing the United States.

In closing, I want to acknowledge my family as the bedrock of my value system. We are hard-working, God-fearing people who keep and treasure our immigrant roots. Public service allows us to give back some of the many blessings that have come our way.

Mr. Chairman, Senator Lugar, Senators, Members of the Committee, I respectfully

ask for your favorable consideration of my nomination and stand ready to respond to any questions that you may have. Thank you.

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July 17, 2008
HP-1089

Paulson to Speak on Markets and the Economy

Secretary Henry M. Paulson, Jr. will deliver remarks next week at The New York Public Library. He will speak on markets and the economy.

Who
Secretary Henry M. Paulson, Jr.

What
Remarks on Markets and the Economy

When
Tuesday, July 22, 8:10 a.m. EDT

Where
The New York Public Library
The Humanities and Social Sciences Library
Fifth Avenue at 42nd Street
New York, N.Y.

Note
Press must register with Nadia Riley at (212) 592-7177 or nadia.riley@nypl.org and enter through the entrance at 11 West 40th Street. Cameras can begin to set-up at 7:00 a.m.

July 21, 2008
HP-1090

Acting Under Secretary for Domestic Finance Anthony Ryan Remarks on Effective Capital Markets and Market Discipline

Boston- Good afternoon and thank you for inviting me to join you today. Before moving to Washington, D.C., I spent twenty years working in financial services here in Boston and so it's good to be back. As a Red Sox fan like many of you, I regularly read the great sports-writers of the *Boston Globe* as they contribute to the perennial sports debate about how offense sells tickets but defense wins championships. While the debate can make for good talk radio, successful coaches can attest that you need both to be competitive over the long run.

Good pitching and good hitting complement one another. Strong defensive players create opportunities for the offense. Likewise, the opposite is also true. Good offense helps defense. You can't tell me that when Big Papi hits a three run shot during the bottom of the 8th inning, that Jonathan Papelbon doesn't feel a bit more confident when he takes the mound to start the 9th inning. The reality is, they are complementary, and collectively they define a winning strategy.

Today, I would propose that the strategy for developing strong, competitive, sustainable and efficient franchises, is not limited to just sports teams, but can be applied to capital markets as well. The hallmarks of a successful player or sports franchise, innovation, flexibility, leadership and discipline, are also traits of successful financial institutions. These traits are also complemented by appropriate oversight and regulations. Collectively, these efforts create a system that delivers benefits to the broader group: in the case of a sports franchise, to the league and business, and in the case of capital markets, to our economy.

During the last several weeks, we unfortunately have seen the consequences of having large, innovative financial institutions without appropriate oversight. Fannie Mae and Freddie Mac are currently the largest sources of mortgage finance in the United States. Their operations grew exponentially over the last decade. This Administration has pushed hard for many years to update and strengthen the GSEs' regulator, so it has powers comparable to bank regulators.

There is little doubt Fannie Mae and Freddie Mac have an effect on overall market stability and must have improved oversight. To address market stability issues immediately, the Secretary has asked for temporary authority to extend an increased line of credit as a liquidity backstop and for the ability to provide a capital backstop to the GSEs. The second part of the Secretary's proposal is to include a consultative role for the Federal Reserve in the new GSE regulator's process to set capital requirements and other prudential standards. The Secretary has asked that these new provisions be included in the House- and Senate-passed GSE legislation. We have been working closely with Congress and expect this legislation to be completed soon.

Market Discipline

Effective capital markets and effective regulatory policy do not happen independently; quite the contrary. The fact is, success is inter-dependent, and the relationship requires cooperation, interaction, and some level of mutual dependence.

In seeking to achieve investment objectives, you and your clients confront many types of risk, ranging from counterparty and liquidity issues to reputational and even career risk. Successful investors must recognize and manage these and other risks effectively. When private-sector participants act in their own self-interests, they exercise their powers of analysis and reason, in turn defining and establishing market discipline. Market discipline is critically important and serves multiple

purposes. It serves to aid investors individually, and it also serves to mitigate the likelihood and severity of a systemic event.

However, despite its many virtues, the presence of market discipline should not be taken for granted. Simply put, it can be compromised and undermined. Potential costs, complacency, and the search for fast and easy rewards can weaken such self-restraint.

In fact, the erosion of market discipline contributed greatly to the challenges we are addressing today. These breakdowns in the system will continue to occupy policy makers and market participants for years to come.

In order to sustain a recovery, we need to see changes in market practices and today I want to discuss the reforms outlined by the President's Working Group on Financial Markets (PWG). However, recommendations alone will not fix this problem. Meaningful change is difficult and it will require leadership. As leaders within your field, you are the ones who can provide the necessary leadership to implement the reforms that are required to restore market disciple and help bring stability back to the financial markets.

After undertaking a rigorous review of the underlying causes of today's turmoil, the PWG released a policy statement in March that included specific recommendations to address the underlying weaknesses that caused the disruptions in our capital markets.

These recommendations cover the practices of a broad array of market practices and participants, including originators of credit, financial institutions, rating agencies, investors, and regulators. The implementation of these recommendations has already begun moving forward, with all parties playing a role. Let me share with you an interim status report.

Mortgage Origination

The first area addressed by the PWG was mortgage origination. In order to restore market discipline, the PWG called for several areas of reform: stronger government oversight of brokers and others involved in the origination process; stronger incentives for originators to use robust underwriting standards and procedures; and vigorous enforcement related to fraudulent transactions and schemes that take advantage of households facing foreclosure.

A Nationwide Mortgage Licensing System has been established to ensure strong, uniform licensing standards for mortgage brokers across all fifty states. Additionally, both the House and Senate have passed legislation that would set minimum standards for licensing and require states to participate in the licensing system or else be subject to a similar licensing database and registration system created and overseen by the Department of Housing and Urban Development.

Federal supervisory agencies have also adopted new policies that will improve mortgage origination. First, federal regulators have issued guidance to improve the underwriting of subprime mortgages, and state authorities have issued comparable guidance in this area. Second, the Federal Reserve has approved changes to Truth in Lending Act (TILA) rules to address concerns about incomplete or misleading mortgage loan advertisements and to require lenders to provide mortgage disclosures more quickly.

The Federal Reserve is also reviewing TILA rules relating to disclosure and is testing potential types of disclosures with consumer focus groups. This work will continue into early 2009. Additionally, under its HOEPA authority the Federal Reserve has finalized new rules that address abuses related to prepayment penalties, failure to escrow for taxes and insurance, stated-income and low-documentation lending, and failure to give adequate consideration to borrowers' ability to repay.

Finally, working together, federal and state authorities have initiated a pilot program to review compliance with consumer protection laws and regulations on underwriting and management oversight at selected non-depository lenders having significant subprime mortgage operations.

Ratings Practices

The second area the PWG addressed was ratings practices. Here we sought reforms to the processes for rating structured credit products to ensure integrity and greater transparency so that investors can make better-informed decisions. To achieve this goal, the PWG recommended that the credit rating agencies disclose their review of originators and underlying collateral, assumptions and models, performance measures, and any conflicts-of-interest. We also want clearer explanations of the meaning and methodology for ratings of structured products.

Actions are being taken here too. A group led by the Securities Industry and Financial Markets Association (SIFMA) is responding to the PWG recommendation with representatives of all constituents to develop further steps that can be taken to ensure the integrity and transparency of ratings, and to foster appropriate use of ratings in risk assessment.

On the supervisory front, the SEC recently issued three sets of proposed rules. The first two bring increased transparency and integrity to the credit ratings process. The third set encourages independent risk analysis by investors and makes clear the purposes and limits of credit ratings for structured products. Taken together, these proposed rules will bring a number of specific improvements to the ratings process. First, they address conflicts of interest by prohibiting credit rating agencies from rating products that they structure. Second, they require rating agencies to review and publicly disclose information on the underlying assets before a rating is released on a structured product.

Next, the proposed rules will require public disclosure of ratings actions and ratings performance measures. In addition, the rules specify disclosure of the way that rating agencies rely on third-party due diligence, how frequently credit ratings are reviewed, whether different models are used for surveillance than for initial ratings, and whether changes made to models are applied retroactively to existing ratings.

Notably, the rules also call for differentiation of ratings for structured products from ratings for corporate and municipal securities. This may be accomplished either through different symbols or by issuing a report disclosing the differences between ratings of structured products and other securities. Finally, other rules seek to ensure that the SEC's own regulations do not encourage investor over-reliance on ratings issued by ratings agencies. The SEC currently is accepting comments on these rule proposals and likely will promulgate final rules later this year.

The PWG is reviewing these changes to determine if these reforms are sufficient to ensure the integrity and transparency of ratings.

Investor Awareness of Risk

With the erosion of market discipline many market participants lost sight of the need for robust risk awareness, and so the PWG also made several recommendations in this area. First, the PWG called for stronger independent assessment of information by investors, fiduciaries, and asset managers to reduce the reliance on ratings agencies. In order to facilitate this independent risk assessment, the PWG also called for enhanced disclosure by originators, underwriters, and sponsors about the collateral used in structured credit products. Finally, the PWG recommended that firms need to improve their disclosure about exposure to off-balance sheet vehicles such as asset-backed commercial paper conduits.

There are many actions are being taken on this front as well. The PWG recommended the formation of another private-sector group to develop recommendations and best practices for improved disclosures for structured products. A group led by the American Securitization Forum (ASF) has developed a draft template for information that should be disclosed to investors that will serve as the basis for disclosure templates for other structured products. The industry already has a template for the disclosure of critical information to asset backed commercial paper investors that is gaining widespread acceptance and is being rapidly adopted by industry participants. Other recommendations from this broad coalition of industry participants are expected later this year.

Overseers of institutional investors are providing guidance for investors and asset managers regarding obtaining sufficient information from sponsors and underwriters

about the risk characteristics of structured products. Supervisors are planning on issuing guidance for underwriters and sponsors of structured finance products requiring them to publicly disclose ratings shopping.

Risk Management

Risk management is another area where we must have improved risk management practices. Strengthened risk management practices at financial institutions, increased oversight of institutions' risk management practices, and more robust valuation models for complex, mortgage-related, and structured products are requirements for strong capital markets.

Global financial institutions are already identifying and are working to address weaknesses in risk management practices. The PWG supported the formation of a private-sector group to reassess implementation of the Counterparty Risk Management Policy Group II's existing guiding principles and recommendations regarding risk management, risk monitoring, and transparency, and to modify or develop new principles and recommendations as necessary to incorporate lessons from the recent turmoil, including lessons regarding valuation practices. This new group intends to issue a report later this summer that focuses on four areas of reform: financial institutions' risk management practices; complex financial products; off-balance sheet activities, including accounting policy and disclosure; and financial market infrastructure, including OTC derivatives.

Supervisors of global financial institutions are closely monitoring the firms' efforts to address risk management weaknesses and taking action if necessary to ensure that weaknesses are addressed. U.S. banking regulators and the SEC are assessing current guidance and developing common guidance to address risk management, including improvements to management information systems; concentration risk management, liquidity risk management, stress testing, and other risk management practices that are necessary to ensure that liquidity and capital cushions are sufficiently robust to absorb extreme system-wide shocks.

U.S. authorities are encouraging other supervisors of global firms to make complementary efforts to develop guidance along the same lines.

Regulatory Practices and Market Infrastructure

The PWG also is working on implementing initiatives regarding two other areas: regulatory practices and market infrastructure. Here we are enhancing regulatory policies to ensure strong risk management practices. We are addressing regulatory capital requirements for firm-wide exposures and both on- and off-balance sheet exposures, and ensuring liquidity cushions are forward looking and adjust appropriately through credit cycles. We also are engaged in efforts to ensure that reporting and disclosure of off-balance sheet vehicles is enhanced.

With respect to market infrastructure, we are encouraging the development of an integrated operational infrastructure for the over-the-counter (OTC) derivatives market that ensures accuracy and timeliness of trade data submission, resolution of trade matching errors, and integrated processing. We are calling for a cash settlement protocol adopted by market participants and incorporated into standard documentation, and for netting, novation and clearing of OTC derivatives contracts by a centralized counterparty. In addition, we are addressing the risks surrounding tri-party repurchase agreements, and the short-term financing and systemic risk implications for capital markets.

Hedge Funds

As hedge fund managers, there is a special role you must play. Over a year ago, the PWG released principles and guidelines regarding private pools of capital. While private pools of capital bring many advantages to our capital markets, they also pose challenges, including systemic risk and investor protection. We must rely on a combination of strong market discipline and regulatory policies to address these risks.

In September 2007, the PWG tasked two private-sector committees, an Asset Managers' Committee and an Investors' Committee, to develop best practices for

their respective groups. Their draft practices were released for public comment in April, and the groups will release final reports this summer.

Similar to your "Sound Practices for Hedge Fund Managers," the draft "Best Practices for Asset Managers" calls on hedge funds to adopt comprehensive best practices in all aspects of their business, including the critical areas of disclosure, valuation of assets, risk management, business operations, compliance and conflicts of interest. The report recommended innovative and far-reaching practices that exceed existing industry standards, and calls for increased accountability for hedge fund managers.

The "Best Practices for Investors" includes both a Fiduciary's Guide and an Investor's Guide. The Fiduciary's Guide provides recommendations to individuals charged with evaluating the appropriateness of hedge funds as a component of an investment portfolio. The Investor's Guide provides recommendations to those charged with executing and administering a hedge fund program once a hedge fund has been added to the investment portfolio. These best practices offer a guide for responsible investment in hedge funds. It is critical to see them implemented.

There also is a need to move forward on a longer-term, strategic basis. Treasury released a Blueprint for Financial Regulatory Reform in March 2008. The current U.S. regulatory structure is not optimally positioned to address the modern financial system with its diversity of market participants, innovation, complexity of financial instruments, convergence of financial intermediaries and trading platforms, and global integration and interconnectedness.

We suggested in the Blueprint a new framework, one that includes a market stability regulator with broad powers focusing on the overall financial system. The market stability regulator would have the ability to evaluate the capital, liquidity, and margin practices across the entire financial system and their potential impact on overall financial stability.

To do this effectively, the market stability regulator would have the ability to collect information from commercial banks, investment banks, insurance companies, hedge funds, and commodity pool operators. Rather than focus on the health of a particular organization, the market stability regulator would focus on whether a firm's or industry's practices threaten overall financial stability. It would have broad powers and the necessary corrective authorities to deal with deficiencies that pose threats to our financial stability.

Our ambition is to frame the debate and put forth a model that can guide all stakeholders as we seek to modernize our financial regulatory structure.

Conclusion

We have a great deal to accomplish in the months ahead. As stakeholders in the asset management industry you must continually uphold and enhance the highest quality standards of excellence. Failure to do so only compromises an industry with deep roots and a proud legacy. It is a privilege to be entrusted with the public's interest and capital. With such a privilege comes great responsibility. To achieve our goals we need to recognize that the responsibility is borne by both the private and public sectors. Building upon the efforts to date, all stakeholders must continue to do more. Collectively, we can strengthen the vitality, stability and integrity of our capital markets.

Thank you again for the opportunity to speak here today.

-30-

July 22, 2008
hp-1091

**Remarks by Secretary Henry M. Paulson, Jr.
on Reinforcing Market Stability and Confidence
at the New York Public Library**

Washington, DC-- Thank you, Catie. I appreciate this opportunity to join you this morning to give my thoughts on current market conditions.

As we all know, the U.S. economy and our financial markets are undergoing a period of stress. We will work through this period, as we always do. Our workers, industries and companies are the most productive, resilient and innovative in the world. Periods of economic difficulty are not new. They are, unfortunately, inevitable. Yet, after every such period, the United States emerges stronger and better poised for robust growth. This time will be no different.

Focus on Market Stability

My focus and highest priority is on stability and confidence in our markets and our financial institutions. Orderly and stable markets are critical for the functioning of our economy and to minimize the impact of the current turmoil on the broader economy. Through stable markets, financial institutions make funds available for small and large companies to borrow and grow, for the entrepreneur to start a new business, for families to buy homes and cars and pay for their children's educations. When people and companies save, borrow, and invest, they put their faith in our markets and our financial institutions.

Working through the current turmoil will take additional time, as markets and financial institutions continue to reassess risk and re-price securities across a number of asset classes and sectors. I have and will continue to encourage financial institutions to strengthen their balance sheets by raising capital, de-leveraging and reviewing dividend policies so that they continue to play their vital role in supporting economic growth. Even in this difficult environment, U.S. financial institutions have raised over $150 billion.

Yet, market challenges have also required policymakers to develop unique solutions. In the Bear Stearns situation, the Federal Reserve took the appropriate and necessary actions for market stability, not just by accepting collateral for a loan to JPMorgan Chase to finance the purchase of Bear Stearns, but also in opening a lending facility for investment banks. Today, our number one priority is market stability as we work through the current market stress. Looking forward, we must balance two very important priorities – better regulation through a more effective updated regulatory structure on the one hand and market discipline to limit moral hazard on the other. A stable system requires that risk-taking bring both reward and loss. Market discipline plays an enormous role in curtailing excessive risk-taking, a role that neither can nor should be completely executed by regulators.

Following the Bear Stearns episode in March, markets became calmer. However, as I often note, our markets won't make progress in a straight line and we should expect additional bumps in the road. We have been experiencing more bumps recently, and until the housing market stabilizes further we should expect some continued stresses in our financial markets.

Safe and Sound Depository Institutions

Last week, our markets witnessed the failure of IndyMac Bank. It was the third largest bank failure in U.S. history and worthy of attention. Yet as large as IndyMac is, it represents only 0.2 percent of total banking industry assets. Well-defined policies and procedures exist for those relatively few times when a federally-insured

bank does fail, and these protect deposits which are insured up to $100,000 per account and help prevent one failure from destabilizing broader financial markets. We saw this in practice at IndyMac. The FDIC took over the bank on a Friday, worked effectively over the weekend, and on Monday morning the bank re-opened for business as usual. No one has or will lose a penny of insured deposits.

The American people have every reason to remain confident that the U.S. banking system is sound. The FDIC has made clear that of the nearly 8,500 insured banks and thrifts that comprise the U.S. banking system, 99 percent are well-capitalized. One thrift and four commercial banks have failed this year; during the 1980's Savings & Loan Crisis there were an average of 255 failures per year – the circumstances then are hardly comparable to today.

And bank failures do not spring up overnight. Regulators carefully monitor all insured banks' adherence to capital ratios and, if an institution is troubled, the bank and the regulators actively work together to avoid a failure.

Non-Bank Financial Institutions and Market Stability

Beyond the insured depositories the financial services industry has changed, and non-bank financial institutions now play a significantly greater role. Our current financial regulatory structure does not adequately reflect this new reality.

Treasury made our recommendations for an optimal structure when we released our Blueprint for a Modernized Financial Regulatory Structure last March. We recommend a U.S. regulatory model based on objectives that more closely link the regulatory structure to the reasons why we regulate. It takes into account the new financial landscape and the role played by non-bank institutions. Because our model is organized by regulatory objective rather than by financial institution category, it can more easily respond and adapt to the ever-changing marketplace. Our Blueprint also recognizes the critical role market discipline plays in maintaining stability.

Looking beyond today's market challenges, we need to get to the point where large, complex financial institutions are not perceived to be too big or too interconnected to fail. Essential to this objective is improved market infrastructure and operating practices to increase transparency and efficiency, especially in the OTC derivatives market and the tri-party repo system. Improved infrastructure will add to market stability and mitigate the likelihood that a failing institution can spur a systemic event. We also need additional powers to manage the resolution, or wind-down, of large non-depository financial institutions, such as larger hedge funds, so as to limit the impact of a failure on the broader financial system.

Finding the right balance between market discipline and market oversight is going to require additional progress on the part of market participants and policymakers. While doing so, it is critical that we maintain the market stability and innovation necessary to support vibrant economic growth.

Over the last several weeks, the need to move more quickly toward an optimal regulatory structure that establishes a prudential financial regulatory system, focused on promoting long-term market stability has become all the more apparent. I look forward to working with Congress and government regulators to achieving this goal.

GSE Importance to Housing Markets and Financial Market Stability

As you know, today we are also working closely with Congress to immediately address the current challenges presented by the housing GSEs Fannie Mae and Freddie Mac, which are among the largest and most interconnected of all global financial institutions. Of the $5 trillion in debt and mortgage backed securities guarantees issued by these two GSEs, over $3 trillion is held by domestic financial institutions including commercial banks, savings and loans, and credit unions, and over $1.5 trillion is held by institutions and central banks overseas. Because of their size and scope, Fannie and Freddie's stability is critical to financial market stability. Investors in our nation and around the world need to know that we understand how important these institutions are to our capital markets broadly, and to the U.S. economy.

The GSEs are also currently the largest sources of mortgage finance in the United States. Their continued activity is central to the speed with which we emerge from this housing correction and remove the underlying uncertainty in our financial markets and financial institutions.

Turning the corner on the housing correction requires homebuyers to return to the market, and homebuyers need available and affordable mortgage financing. Housing is not only important to our economy; it is also the largest factor currently impacting our financial markets. The sooner we work through the housing correction, the sooner home prices will stabilize, and uncertainty about the values of mortgage-related assets will be more easily determined. So now, more than ever, we need Fannie and Freddie out there, financing mortgages. That means we must, in the short term, take steps to boost confidence in the GSEs, while also taking steps to address the potential systemic risk they pose.

My views on their structure are well known – they are an odd construct, with a difficult dual mandate to serve both a public mission and private shareholders. The GSEs are providing an essential function when they securitize and guarantee high-quality mortgages. This attracts capital into mortgage markets and lowers borrowing costs for homebuyers.

For years, we have advocated that the GSEs need a stronger and world-class regulator, with the authorities appropriate and necessary for the task. From the time I arrived in Washington I have worked with Congress to achieve this objective. Congress is very near completing its work to create that regulator, and it must do so quickly. And, as it does so, last week we asked for the addition of temporary provisions to promote market stability and confidence – not just in the GSEs but throughout the financial system.

Recent developments convinced policymakers and the GSEs of the need to increase confidence and respond to market concerns by providing assurances of their access, if necessary, to liquidity and capital on a temporary basis.

After consultations with Congressional leaders and U.S. financial regulators, last week I put forward a proposal that will accomplish this in two phases. The proposal is aimed at supporting the short and longer term stability of financial markets, not just these two enterprises. I would rather not be in the position of asking for extraordinary authorities to support the GSEs. But I am playing the hand that I have been dealt. There is a need to support efforts that strengthen Fannie and Freddie's ability to continue to play their important role in financing mortgages and in our capital markets more broadly.

The first phase of our proposal is aimed at immediate market confidence and stability. I have asked Congress to provide temporary authority for 18 months to provide a liquidity backstop and a capital backstop to the GSEs. There are no plans to access either of these. As I assured Congress last week, if using either of these authorities does become necessary, we would do so only under terms and conditions that protect the U.S. taxpayer and are agreed to by both Treasury and the GSE.

We need to act in the short-term because the GSEs are vital institutions in our capital markets today and are vital to emerging from the housing correction. We also know that for long-term market stability we must address the potential systemic risk these entities pose to taxpayers and markets going forward

That's why we are urging Congress to finish legislation creating a world-class GSE regulator, including a consultative role for the Federal Reserve in the new GSE regulator's process for setting capital requirements and other prudential standards. As this new regulator implements its mandate, we expect and welcome a larger examination of the structural issues inherent in these GSEs, so that we don't find ourselves in this same position again in the future.

I have been consulting closely with members of Congress from both houses and both sides of the aisle. I am confident they recognize the demands of the current situation, and will act to complete work on this legislation this week.

Conclusion

I am well aware that financial market and housing challenges continue to concern America's families. Progress has not come in a straight line, and we need to remain patient as we work through these challenges. Policymakers and regulators are vigilant in our efforts. We are using all available tools and seeking new ones, not merely for immediate concerns but also to do what we can to ensure that these issues do not recur.

I believe that the United States is on the right path to resolving market disruptions and building a stronger financial system. Increasingly, our capital markets will reflect the underlying economy, and here we are fortunate that our long-term fundamentals are strong. Thank you and I am pleased to answer your questions.

-30-

July 23, 2008
HP-1092

**Statement by Secretary Henry M. Paulson, Jr.
on House Passage of Housing Bill**

Washington - Treasury Secretary Henry M. Paulson, Jr. issued the following statement today on House passage of the housing bill:

"I'm pleased the House acted quickly to pass an important GSE bill that will provide temporary authorities to give confidence to markets and will create a strong, independent regulator better able to address the risks these enterprises pose.

"I am disappointed that the legislation also includes extraneous provisions that we have opposed as detrimental to our efforts to get through the housing correction quickly.

"However, as I have said before, the GSE portions of this bill are orders of magnitude more important to turning the corner on the housing correction and supporting our markets and our economy.

"I look forward to working with the Senate to get legislation to the President's desk this week."

-30-

July 30, 2008
HP-1093

Treasury Acting Under Secretary for Domestic Finance Anthony W. Ryan
August 2008 Quarterly Refunding Statement

Washington - We are offering $27.0 billion of Treasury securities to refund approximately $43.5 billion of privately held securities maturing or called on August 15 and to pay down approximately $16.5 billion. The securities are:

- A new 10-year note in the amount of $17.0 billion, maturing August 15, 2018;
- A new 29 ¾-year bond in the amount of $10.0 billion, maturing May 15, 2038

These securities will be auctioned on a yield basis at 1:00 p.m. EDT on Wednesday, August 6, and Thursday, August 7, respectively. Both of these auctions will settle on Friday, August 15. The balance of our financing requirements will be met with weekly bills, monthly 52-week bills, monthly 2-year and 5-year notes, the September 10-year note reopening, and the October 10-year TIPS and 5-year TIPS reopenings.

Treasury also expects to issue cash management bills on a monthly basis during the quarter.

Borrowing Needs in Fiscal Years 2008 and 2009

Over the course of the fiscal year, changes in economic conditions, financial markets, and fiscal policy as well as nonmarketable debt issuance have caused an increase in Treasury's marketable borrowing needs.

Treasury has responded to the increase in marketable borrowing requirements by increasing issuance sizes of regular bills, the frequency, terms, and issuance sizes of cash management bills, and the issuance sizes of nominal coupon security offerings. In addition, Treasury reintroduced a 52-week bill, with auctions occurring once every four weeks.

Treasury will continue to monitor projected financing needs and make adjustments as necessary including, but not limited to, considering a second reopening of the 10-year note in the month following the first reopening and moving to quarterly new issue 30-year bond auctions.

We will make an announcement at the November 2008 quarterly refunding regarding any changes to the calendar, including any decision regarding a second reopening of the 10-year note or moving to quarterly new issue 30-year bonds.

Debt Subject to Limit

In the recent housing legislation, the statutory debt limit was increased from $9.815 trillion to $10.615 trillion. We applaud the efforts of Congress for being proactive in managing the debt limit.

Treasury Cash and Debt Modernization

Treasury is pleased to announce another milestone in efforts to modernize cash and debt management practices. Beginning in November 2008, the Quarterly Dealer Agenda will be prepared in both its current paper format and in an electronic format. This change will make submission, collection, and analysis of survey data more efficient. We expect to eliminate the paper format and move to a fully

electronic platform in 2009.

Please send comments and suggestions on these subjects or others relating to Treasury debt management to debt.management@do.treas.gov.

The next quarterly refunding announcement will take place on Wednesday, November 5, 2008.

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July 30, 2008
HP-1094

**Report To The Secretary Of The Treasury
From The
Treasury Borrowing Advisory Committee
Of The
Securities Industry and
Financial Markets Association
July 29, 2008**

Since the Committee's last meeting in late April, credit conditions have remained challenging and the outlook for the economy uncertain. A myriad of actions on the part of the Federal Reserve and the Federal government have prevented the strains in credit and housing markets from undermining the U.S. financial system. Nonetheless, the ongoing elevated nature of many money and credit market spreads underscore the still fragile nature of markets and the lingering concerns about counterparty risk.

Considering the magnitude of the financial shock, economic growth held up relatively well in the first half of 2008 due in part to policymakers' efforts. GDP in the first six months of the year appears to have advanced by about 1½% to 1¾%. An improved net export position, joined with a boost to consumer spending in the latest quarter from tax rebates, contributed importantly to this performance. Yet, the economy's prospects ahead remain uncertain. The boost to household spending from rebates is temporary and will reverse later this year. Moreover, housing continues to be a drag through a variety of channels. The still notably unbalanced nature of housing supply and demand is sustaining downward pressure on home prices and related securities held by major financial intermediaries. On balance, the outlook for the economy will remain clouded until credit conditions improve and financial intermediation begins to function more smoothly.

Headline inflation remains elevated due to rapid price increases for food and energy. Softening economic growth is having a moderating effect on an array of other consumer prices, especially for credit-sensitive, large-ticket purchases such as household durables and motor vehicles. Core consumer prices continue to rise in a 2% to 2½% range. Chances favor some improvement in these measures amid tougher financial conditions, softer home prices and higher unemployment. Nonetheless, elevated costs for everyday commodities and their potential effect on inflation expectations, may sustain concerns about inflationary pressures.

Federal Reserve officials have lowered the Federal funds target to 2% and now view monetary policy as positioned appropriately given the outlook for growth and inflation. Futures markets have oscillated considerably in recent months and currently anticipate a roughly quarter-point hike in the policy rate by year-end.

The economic slowdown coupled with several special factors has created a marked deterioration in the U.S. budget outlook and an increase in the net borrowing needs by the Treasury. The deficit for fiscal year 2008 ending in September is now expected to be in excess of $400 billion--a sharp increase from the previous year's deficit of $163 billion, and looking forward, most private forecasts for the FY 2009 deficit exceed $500 billion.

The deterioration in the fiscal situation stems primarily from the significant turn in tax receipts while outlays have remained elevated. For example, the year-over-year change in cumulative individual and corporate tax receipts through June have fallen 4.3% in 2008 whereas tax receipt growth for the same period in the three previous fiscal years ranged between +11% and +21%. At the same time, the increase in fiscal outlays at 6.6% for the last twelve months is similar to previous years.

Net borrowing needs by the Treasury has been further exacerbated by several factors including a large change in the demand for State and Local Government securities (SLGs) and the recent need for the FDIC to tap its funds at the Treasury

Pressures in the municipal bond market have significantly reduced the ability for municipalities to pre-refund and refinance their debt over the past year and has led to a redemption of approximately $30 billion of SLGs on a year-to-date basis. This compares to a net issuance of approximately $50 billion of such securities a year ago for a net swing of almost $80 billion. This change directly influences how much net marketable borrowing the Treasury must undertake.

And, lastly, the recent actions by the FDIC to take over several U.S. banks, including Indy Mac, has led to the need for the Treasury to borrow additional funds to meet the needs of the FDIC.

With this as a backdrop, the Committee tackled the Treasury's first charge which was to seek our advice on debt issuance over the coming quarters.

There was a universal consensus on the Committee that given the marked change in net borrowing needs described above, and the prospects for further deterioration in the fiscal outlook, that the Treasury should increase the size and frequency of its current issuance calendar and consider adding additional issues over the near and intermediate term.

After much discussion, the Committee concluded that Treasury should consider moving to a monthly issuance of ten-year notes, to a quarterly issuance of thirty-year bonds and re-introduce a three-year note over the coming quarters to meet the growing financing needs of the U.S. government.

The Committee also discussed the merits of several alternative maturity issues but concluded that the Treasury should first focus on the above issues which have proven in the past to be well accepted by the marketplace.

In the second charge, the Committee was asked to address current conditions in the credit markets, including the perceptions of risk in light of previously implemented funding facilities introduced by the Federal Reserve, as well as the additional recent initiatives by the Treasury and Federal Reserve.

One member presented a comprehensive analysis of the aforementioned issues (attached), starting with a discussion of Libor vs OIS (Overnight index Swap) spreads. The analysis showed how the initial introduction of the TAF (Term Auction Facility) program in December '07 quickly improved funding strains into year-end, and was later enhanced by the increase in the TAF in early January, although global equity market volatility soon unwound some of this benefit.

Subsequent to this however, further TAF increases and the introduction of the TSLF (Term Securities Lending Facility) and PDCF (Primary Dealer Credit Facility) have reduced the term interbank premium in 1-month money, yet 3-month money remains persistently wide. The conclusion was that the growth in size of the TAF has had a tangible impact on Libor/OIS spreads, and that a 3-month TAF would further alleviate funding pressure.

The data shows that while early TAF results demonstrated strong performance, the results were much closer to interbank levels than OIS during March, while concerns that the Libor fixing process understated the true cost of borrowing in the interbank market.
The "stigma" associated with Discount Window borrowing may have contributed to the TAF trading like the interbank markets, as banks paid up to access money away from the Window.

The member notes that, while the TAF program was widely accepted and utilized, the TSLF was not as widely utilized at inception. The member felt that its execution in the form of a collateral swap, with a more restrictive collateral schedule, plus its being an auction for Treasury tri-party repo, not cash were limitations to its effectiveness. Yet, over the past few weeks, as MBS/Treasury repo spreads

widened, the program became more widely utilized, and suggested the underlying confidence and potential easing of credit stress through this program having been in place.

The results of PDCF and Primary Credit Discount Window borrowings have shown that funding conditions in the dealer community have also improved, alongside of a perceived stabilization in the bank funding arena. The introduction of the PDCF had a clear and immediate impact on spreads once announced in March, yet it is difficult to assess the true impact of its presence today.

In addition, the member commented that the recent flight to quality buying in the wake of GSE uncertainty has seen T-Bill and Treasury repo richen once again, yet not back to the extreme levels seen in March. The conclusion was that the Fed's liquidity provisions overall are having a tangible impact on credit conditions in the market.

The member went on to discuss the implications for Treasury of the volatility of global financial markets and the movement of investment allocations across asset classes. The re-distribution of Money Fund assets, re-allocations into Equities, as well as Treasury issuance levels will be critical drivers of demand for bills, as well as discount notes.

A number of members also cited other factors as having significant influences over bill and note pricing in the months ahead.

The Committee's third charge from the Treasury was to review the success of the TIPs market to date and to get our views on any suggested changes in issuance.

One member of the Committee prepared a presentation on the TIPs market in advance and presented his conclusion to the group. A copy of that presentation is attached to the release of these minutes.

This member noted that the total outstanding balance of TIPs is now almost $500 billion since first being introduced 10 years ago in 1998. TIPS have enjoyed a mixed history over those ten years both from an investor's acceptance and for the Treasury as issuer.

Interestingly, there has been almost no private inflation-linked securities introduced over this time and consequently, it is hard to appreciate how much of a "premium" TIPS have enjoyed by being backed by the full faith and credit of the U.S. government.

This member noted that private issuers have been reluctant to issue such securities because they view them as costly and they have been unable to receive hedge accounting treatment even when they may have an asset tied to inflation to hedge.

This member also believes that TIPs have proven very costly to the Treasury as a financing tool over their life. This cost is both a result of measured inflation being higher than the "break-even" level that existed at the time of their issue relative to nominal coupon Treasury securities of similar maturities and a result of the significantly reduced level of liquidity enjoyed by TIPs relative to nominals.

For example, a chart was presented that showed the average daily volume in the TIPs market is only about 2% of outstanding supply where nominal Treasuries have a daily turnover of closer to 14% of outstanding supply.

This member estimates that the cumulative cost of the TIPs program to the Treasury since inception, when comparing the total expense relative to nominal bonds issued at a similar time, approaches $30 billion with the bulk of that cost a direct result of significantly higher inflation than estimated by the markets "breakeven" level when issued.

This member and others were quick to point out that it is entirely possible that future "excess costs" might be negative--meaning TIPS prove cheaper to issue if future inflation moves lower over time than the break-even issuance levels. However, with a ten-year experience period to measure, TIPs have certainly not been an attractive form of financing for the U.S. Treasury to date.

Through discussion among various members of the Committee, there was a consensus that the Treasury should take this data as an indication that the TIPs program should at a minimum play a smaller relative role in meeting its future financing needs. In addition, as this Committee has opined previously, the Treasury should consider eliminating the 5-year TIPs issue. Its issuance should focus on longer-dated issues which better meet the needs of investors who are seeking to hedge the inflationary aspects of their liabilities, such as pension funds and selected insurance companies.

Lastly, one member noted that one of the original problems with TIPs, that still exists today, is that individuals must pay taxes on the total income of the security including the increase in principal that results from inflation while only receiving a coupon which is lower than this total income. This member pointed out that this structural flaw in the security has reduced its attractiveness and acceptance from inception.

In the final section of the charge, the committee considered the composition of marketable financing for the July-September Quarter to refund the $43.5 billion of privately held notes and bonds maturing August 15, 2008. The Committee recommended a $16 billion 10-year note due August 15, 2018 and a $10 billion 30-year bond due August 15, 2038. For the remainder of the quarter, the Committee recommends $31 billion 2-year notes in August and September, $21 billion 5-year notes in August and September, and a $12 billion re-opening of the 10-year note in September.

For the October-December quarter, the Committee recommended financing as found in the attached table. Relevant figures included three 2-year note issuances monthly, three 5-year note issuances monthly, a 10-year note issuance in November followed by a re-opening in December, a 30-year bond in November, as well as a 10-year TIPs note in October, and a 20-year TIPS re-opening later that same month.

Respectfully submitted
Keith T. Anderson
Chairman

Rick Rieder
Vice Chairman

Attachments (2)
Table Q3 08
Table Q4 08

REPORTS

- Table Q3 08
- Table Q4 08

US TREASURY FINANCING SCHEDULE FOR 3rd QUARTER 2008
BILLIONS OF DOLLARS

ISSUE	ANNOUNCEMENT DATE	AUCTION DATE	SETTLEMENT DATE	OFFERED AMOUNT 4-WK	3-MO	6-MO	12-MO	MATURING AMOUNT	NEW MONEY
4-WEEK AND 3&6 MONTH BILLS	6/26	6/30	7/3	27.00	23.00	22.00	17.00	66.00	23.00
	7/3	7/7	7/10	28.00	24.00	23.00		70.50	4.50
	7/10	7/14	7/17	34.00	24.00	23.00		65.50	15.50
	7/17	7/21	7/24	28.00	24.00	23.00		64.00	11.00
	7/24	7/28	7/31	*22.00*	*24.00*	*23.00*	*19.00*	*71.00*	*17.00*
	7/31	8/4	8/7	*30.00*	*26.00*	*24.00*		*73.00*	*7.00*
	8/7	8/11	8/14	*35.00*	*26.00*	*24.00*		*80.00*	*5.00*
	8/14	8/18	8/21	*35.00*	*26.00*	*24.00*		*75.00*	*10.00*
	8/21	8/25	8/28	*32.00*	*26.00*	*24.00*	*19.00*	*69.00*	*32.00*
	8/28	9/2	9/4	*30.00*	*26.00*	*24.00*		*77.00*	*3.00*
	9/4	9/8	9/11	*25.00*	*26.00*	*24.00*		*81.00*	*-6.00*
	9/11	9/15	9/18	*20.00*	*23.00*	*23.00*		*80.00*	*-14.00*
	9/18	9/22	9/25	*20.00*	*23.00*	*23.00*	*19.00*	*76.00*	*9.00*
					991.00			*948.00*	*117.00*
CASH MANAGEMENT BILLS									
7-DAY BILL		7/8	7/9		*6.00*			*6.00*	*0.00*
	Matures 7/17								
31-DAY BILL		8/14	8/15		*40.00*			*40.00*	*0.00*
	Matures 9/15								
13-DAY BILL		9/2	9/3		*12.00*			*12.00*	*0.00*
	Matures 9/16								
126-DAY BILL		5/14	5/15		*0.00*			*32.00*	*-32.00*
	Matures 9/18								
									-32.00
COUPONS						CHANGE IN SIZE			
10-Year TIPS	7/7	7/10	7/15		8.00				8.00
20-Year TIPS ®	7/17	7/22	7/31		6.00				
2-Year Note	7/21	7/23	7/31		31.00	1.00			
5-Year Note	7/21	7/24	7/31		21.00	1.00		20.00	38.00
10-Year Note	7/30	8/6	8/15		*17.00*	*2.00*			
30-Year Bond	7/30	8/7	8/15		*11.00*	*2.00*		*43.50*	*-15.50*
2-Year Note	8/25	8/27	9/2		*31.00*				
5-year Note	8/25	8/28	9/2		*21.00*			*22.00*	*30.00*
10-Year Note®	9/8	9/11	9/15		*12.00*	*1.00*		*14.50*	*-2.50*
2-Year Note	9/22	9/24	9/30		*31.00*				
5-year Note	9/22	9/25	9/30		*21.00*			*19.10*	*32.90*
					210.00			*119.10*	*90.90*

Estimates are italicized

NET CASH RAISED THIS QUARTER: 175.90

R = Reopening

US TREASURY FINANCING SCHEDULE FOR 4th QUARTER 2008
BILLIONS OF DOLLARS

ISSUE	ANNOUNCEMENT DATE	AUCTION DATE	SETTLEMENT DATE	OFFERED AMOUNT 4-WK	3-MO	6-MO	12-MO	MATURING AMOUNT	NEW MONEY
4-WEEK AND 3&6 MONTH BILLS	9/25	9/29	10/2	*17.00*	*23.00*	*23.00*		*74.00*	*-11.00*
	10/2	10/6	10/9	*17.00*	*23.00*	*23.00*		*70.00*	*-7.00*
	10/9	10/14	10/16	*15.00*	*23.00*	*23.00*		*64.00*	*-3.00*
	10/16	10/20	10/23	*17.00*	*23.00*	*23.00*	*19.00*	*64.00*	*18.00*
	10/23	10/27	10/30	*20.00*	*23.00*	*23.00*		*61.00*	*5.00*
	10/30	11/3	11/6	*20.00*	*23.00*	*23.00*		*64.00*	*2.00*
	11/6	11/10	11/13	*25.00*	*23.00*	*23.00*		*64.00*	*7.00*
	11/13	11/17	11/20	*30.00*	*23.00*	*23.00*	*19.00*	*66.00*	*29.00*
	11/20	11/24	11/26	*30.00*	*23.00*	*23.00*		*69.00*	*7.00*
	11/26	12/1	12/4	*30.00*	*23.00*	*23.00*		*70.00*	*6.00*
	12/4	12/8	12/11	*20.00*	*23.00*	*23.00*		*75.00*	*-9.00*
	12/11	12/15	12/18	*10.00*	*23.00*	*23.00*	*19.00*	*77.00*	*-2.00*
	12/18	12/22	12/25	*10.00*	*23.00*	*23.00*		*76.00*	*-20.00*
					859.00			*894.00*	*22.00*
CASH MANAGEMENT BILLS									
32-DAY BILL	Matures 12/15	11/12	11/13		*18.00*			*18.00*	*0.00*
19-DAY BILL	Matures 12/15	11/25	11/26		*32.00*			*32.00*	*0.00*
5-DAY BILL	Matures 12/15	12/9	12/10		*9.00*			*9.00*	*0.00*
									0.00
COUPONS						CHANGE IN SIZE			
10-Year TIPS	10/6	10/8	10/15		*7.00*	*1.00*			*7.00*
20-Year TIPS ®	10/23	10/27	10/31		*7.00*	*1.00*			
2-Year Note	10/27	10/28	10/31		*31.00*				
5-Year Note	10/27	10/30	10/31		*21.00*			*20.00*	*39.00*
10-Year Note	11/5	11/12	11/17		*17.00*				
30-Year Bond	11/5	11/13	11/17		*7.00*	*1.00*		*43.50*	*-19.50*
2-Year Note	11/24	11/25	12/1		*31.00*				
5-year Note	11/24	11/26	12/1		*21.00*			*22.00*	*30.00*
10-Year Note®	12/8	12/11	12/15		*12.00*			*14.50*	*-2.50*
2-Year Note	12/22	12/29	12/31		*31.00*				
5-year Note	12/22	12/30	12/31		*21.00*			*19.10*	*32.90*
					206.00			*119.10*	*86.90*

Estimates are italicized

NET CASH RAISED THIS QUARTER: 108.90

R = Reopening

July 30, 2008
HP-1095

Minutes of the Meeting of the
Treasury Borrowing Advisory Committee
Of the Securities Industry and Financial Markets Association
July 29, 2008

The Committee convened in closed session at the Hay-Adams Hotel at 10:30 a.m. All Committee members were present. Acting Undersecretary for Domestic Finance Anthony Ryan and Office of Debt Management Director Karthik Ramanathan welcomed the Committee and gave them the charge.

The first item on the charge related to Treasury's financing needs in the coming years as well as current and medium-term trends in the economic outlook. In particular, Treasury sought the Committee's advice on whether the recent adjustments to the financing schedule provided Treasury with sufficient debt management tools to handle a wide range of budgetary and financing outcomes, or if additional adjustments should be considered.

To provide background, Director Ramanathan delivered a presentation to the Committee which highlighted current credit market conditions and potential factors to consider in addressing this issue. In particular, current credit market conditions remained volatile, and potential pressures on corporate tax receipts and individual withheld taxes could increase Treasury's borrowing needs in FY 2008 and FY 2009.

Director Ramanathan noted that marketable borrowing – i.e. borrowing from the public – is projected to total $555 billion in FY 2008 versus just $134 billion for FY 2007, and that this large increase warranted the Committee's focus.

The potential weakness in receipts as a result of the challenges facing the economy as well as reduced non-marketable debt issuance, large redemptions by the Federal Reserve in conjunction with its various liquidity initiatives, and expedited payments related to the fiscal stimulus package – all within a compressed time period - necessitated the increased issuance of Treasury bills, cash management bills, and shorter dated nominal coupons. Redemptions and outright sales by the Federal Reserve since the beginning of the fiscal year for liquidity purposes have resulted in the Treasury's need to issue over $150 billion in additional bills and coupons. Moreover, state and local government issuance for which net issuance was $58 billion in fiscal year 2007 versus total a net redemption of $10 billion in 2008 fiscal year to date.

Director Ramanathan also noted that total cash management bills in FY 2008 year to date total over $300 billion versus about $250 billion for all of FY 2007. At the same time, 2-year note issue sizes have increased $13 billion year to date and 5-year note issue sizes have increased $8 billion. In addition to increasing bills by over $200 billion this fiscal year, Treasury introduced a monthly 52-week bill in July 2008. Nonetheless, debt rollover and average portfolio metrics have changed modestly and remain within historical ranges.

Based on deficit projections from the recently released Mid Session Review, as well as estimates provided by primary dealers of $413 billion for FY 2008 and $422 billion for FY 2009, Director Ramanathan noted that Treasury's additional funding needs may need to be focused on other nominal coupon issuances beyond the short end of the curve. While the 2-year note to 5-year note sector raises cash in FY09, Treasury needs to be flexible beyond that time horizon as a result of the uncertainty regarding financing needs and due to the debt maturity profile of the portfolio. Treasury will continue to adjust issuance sizes in the front of the curve, but also look to adjustments in the medium to longer dated sector of the existing curve to meet borrowing needs.

With these highlights, Director Ramanathan asked the Committee its views on debt issuance options and the optimal financing strategy given current projections and constraints.

A Committee member began by asking about the average maturity of the debt, noting that Treasury had over the last year issued a significant amount of debt in bills and short to intermediate coupons. Director Ramanathan explained that the current average maturity was 56 months, well within the historical norms of the last 30 years. Treasury does not target an average maturity at this time, but feels comfortable with this measure being within historical norms as long as overall flexibility is maintained.

Another Committee member asked if the volatility in the cash balance was typical of prior years. Director Ramanathan replied that while cash balances maintain a seasonal pattern, the current fiscal year has seen more volatility due to many factors including liquidity intitatives, stimulus payments, unexpected outlays, and a decline in the growth of receipts.

The member pointed out that Treasury has benefited from the flight to quality, but needs to consider the situation in which credit market conditions improve. Several members stated that Treasury's issuance of bills was clear and transparent given its needs, and that at some point, the Federal Reserve would look to reconstitute its portfolio. As a result, Treasury's marketable borrowing needs would decline. Another member commented that the short to intermediate coupon sector has seen significant increases in issue sizes and that moving further out the curve was prudent.

Another member pointed out that there was a significant uncertainty in the fiscal situation posed by dislocations in the credit markets, the slowdown in the economy, supplemental expenditures, and the imminent need for large entitlement spending (Social Security, Medicare, and Medicaid, etc.). Given the recent increases in shorter term funding and the sizable projected borrowing needs going forward, the member believed that this may be the time to recognize that the borrowing needs were becoming more structural. This member continued by stating that Treasury should consider increasing its maturity profile using existing securities to meet these financing needs.

A discussion followed regarding the best method for Treasury to raise cash and reduce rollover risk. One member, noting the chart with the maturity profile indicated that there was room to add issuance that matures in the 2011 to 2013 region and also to add maturities in the 2019 to 2028 region. This member suggested adding 3-year notes or 10-year notes to more evenly distribute the debt profile..

Another member suggested that Treasury first consider issuing 10-year notes monthly, either through a double reopening or through new initial offerings of 10-year notes each month. This same member also suggested that Treasury offer new initial quarterly 30-year bonds, as opposed to the current practice of offering a combination of new and reopened 30-year bonds. Another member stated that there would be substantial demand for securities greater than 5-year in length from investors seeking to add duration. Several members stated that there may also be substantial demand for longer-term products, specifically 10-year notes, from accounts seeking to hedge mortgage duration.

A few members noted that the current 30-year auction cycle with an initial offering and reopening with accrued interest was unduly, and that Treasury should switch to original issue 30-year bonds. Director Ramanathan noted that Treasury moved to the current cycle of 30-year bond issuance to enhance liquidity in the STRIPS market by adding May/November maturity points, but that Treasury understood that such an adjustment may improve the debt maturity profile.

Alternative maturity points were discussed briefly by the committee. One member commented that previous issues of 4-year notes, 7-year notes, and 20-year bonds always traded at a discount. This member thought it would be costly to issue at those points or any "new" points outside of current points at this time. Another member stated that if Treasury were to increase 10-year and 30-year issuance, it could then reintroduce a 3-year to meet even greater than expected borrowing needs as well as to prevent average maturity from extending too far. Another member stated given the projected secular borrowing needs, Treasury should

consider new liquidity points, including 50-year bonds or callable issues, but that such issuances we unnecessary at this point and prior to all of the other adjustments Treasury could make in their place.

A general consensus developed that Treasury should consider issuing 10-year notes with two reopenings instead of one reopening, and also move to new issue quarterly 30-year bonds. In addition, the Committee generally agreed that there was additional room in the front end of the curve to make modest increases in 2-year and 5-year notes, and that further deterioration in the fiscal outlook could be met by reintroducing the 3-year note or other such securities.

After finishing this discussion relate dto the fiscal outlook, the Committee moved on to the second item on the charge dealing with credit market conditions. The presenting member began by reviewing the history of the funding strains that were characteristic of recent credit market conditions. The member noted that LIBOR/OIS spreads were significantly more volatile and were trading at elevated levels relative to the historical trends. Similarly, credit default swaps for banks were trading higher. High volatility in LIBOR/OIS reduced investor confidence by creating strains in the repo markets, resulting in wider bid-ask spreads and less liquidity.

The Committee member then discussed the various Federal Reserve initiatives designed to enhance liquidity. The presenter began with the a discussion of the Term Auction Facility (TAF) noting that it had grown in size from $40 billion from its inception in December of 2007 to its current size of $150 billion. At the current size, bid-to-cover ratios were around 1, suggesting that some level of equilibrium had been reached. The presenting member suggested that while the TAF has been effective in reducing 1 month LIBOR/OIS spreads lower by over 60bps, 3 month LIBOR/OIS spreads remained elevated at 80 bps. The presenting member suggested extending the TAF to 90-days to complement the current 1-month TAF. The presenting member then provided background on the Treasury Securities Lending Facility (TSLF) and the Primary Dealer Credit Facility (PDCF) as well as their impact on Treasury issuance. The presenting member noted that Treasury Bills and Treasury repo have cheapened due to increased Treasury issuance and as a result of the initiatives of the Federal Reserve.

The presenting member then moved on to investor activity and sentiment. The presenting member noted the increase of assets flowing into money market funds. The member noted that a reconstitution of the SOMA portfolio could mitigate any significant improvement in market conditions, but that Treasury would be prudent in extending its portfolio. The presenting member also noted that GSE discount note issuance has doubled and that the Federal Home Loan Bank had provided $380 billion of funding in return for mortgage collateral.

After the presentation was completed, Committee members commented on the various issues related to credit markets. One member commented that tri-party best practices would be extremely helpful especially if it included a discussion on clearing agent responsibilities. One member suggested regulation in the repo market might prevent some of the fails. Another member remarked that if issues like rollover risk in tri-party repo were addressed, investor confidence would further benefit. Finally one member suggested that concerns in the repo market should be resolved before PDCF is eliminated.

The Committee then moved on to the second presentation to Treasury which focused on TIPS and trends in inflation. The presenting member begun by noting that while headline CPI should remain well above 5% for the rest of the year, it is expected to collapse to core next year even if oil were to increase an additional $10 from current levels. The Committee member then noted that most surveys related to inflation lacked any significant predictive power and tended to be reactive to current inflation.

The presenting member noted that even with $497 outstanding in the TIPS market, daily trading volume is estimated to be $8 billion, representing a daily turnover of total outstanding of about 2%. By comparison, average daily turnover in the $4 trillion nominal Treasury market is estimated to be nearly 14%. The member pointed out that TIPS seem to have reached a plateau in terms of trading volume despite Treasury's continued efforts to grow the market. The member also stated that the TIPS market appealed to "buy-and-hold" investors while the nominal market attracted many more traders.

The presenting member then stated that TIPS have been a good value to investors, helping them to diversify inflation risks in fixed income portfolios and to express views on realized and expected inflation. The key downside for investors is the illiquidity of the product. Moreover, liquidity does not seem likely to improve given the private sector's reluctance to issue inflation indexed securities. This reluctance on the part of private issuers to issue such debt reflects very high costs (and uncertainty) associated with such issuance, very little fundamental depth of demand, and FAS-133 hedge accounting related issues.

On the other hand, from Treasury's perspective, while TIPS have modestly diversified the investor base, there have been substantial associated costs. The presenting member developed a cost model comparing TIPS issuance versus potential nominal coupon issuance, and concluded that the aggregate cost of the TIPS program was over $30 billion. This cost reflects the fact that realized inflation has been higher than expectations.

The member noted that excess expense of the TIPS program compared to the equivalent amount of nominal issuance is 30% of the overall program expense this year. The cost for the lack of liquidity in TIPS makes up 22% of the excess cost, or approximately $1 billion a year. The presenting member viewed this cost as non-transient. The other 78% of the excess cost was related to the difference between realized inflation and expectations. The presenting member measured liquidity differentials by comparing TIPS and nominal asset swap spreads.

Finally, the presenting member stated that TIPS did not gain the same flight to quality bid that nominal securities did in the recent credit market tightening which in turn caused an increase in the cost of 5-year TIPS relative to the 10-year TIPS and 20-year TIPS. The Committee member concluded the presentation by stating that extending the average maturity of the TIPS portfolio was not so obvious given variable demand at the 20-year point.

The Committee generally agreed that an increase of average maturity in the TIPS program would be best accomplished by reducing or eliminating 5-year TIPS issuance. There was general agreement that given the excess cost to date and the non-transient liquidity premium of TIPS, inflation indexed secruties over the past 10 years have proven to be a less efficient funding mechanism given Treasury's objective of the lowest cost of borrowing over time. The Committee also reiterated its previous suggestion of moderating the growth of the program and eliminating 5-year TIPS issuance.

Director Ramanathan responded by stating that Treasury remained committed to the TIPS, but that a moderation in the growth of the program has occurred given the pace of issuance ver the past ten years relative to nominal issuance.

One member remarked that the lack of a swaps market for TIPS or any sort of liquid CPI-U NSA inflation derivatives market made the TIPS market unattractive to private issuers. This factor helped to explain why TIPS were currently a more costly financing vehicle for Treasury relative to comparable nominal issuance. Another member stated that many investors were not interested in hedging CPI-U NSA. The lack of an inflation derivatives market also prevented short sales of TIPS, which reduced trading volumes and helped explain why there was no flight-to-quality buying in stressed markets.

Another member stated that TIPS should not be considered a growth product in the Treasury debt issuance portfolio. The product was complicated to price, the return profiles were difficult to explain, and the tax treatment made it unattractive to many accounts.

Another member noted, however, that globally there was growing interest in inflation-indexed products, and that if inflation were to continue to rise, there could be additional demand for TIPS. One member suggested that much of that interest was driven by regulatory induced demand that required investors to hold assets that are inflation indexed.

To conclude the discussion, a member asked if another distribution mechanism should be considered for selling TIPS such as by subscription with a price determined by Treasury. Members recommended that Treasury maintain its auction disctibutin method, but study the alternative strategy further.

The meeting adjourned at 11:56 a.m.

The Committee reconvened at the Hay-Adams Hotel at 6:00 p.m. All of the Committee members were present. The Chairman presented the Committee report to Acting Under Secretary Ryan.

The Committee then reviewed the financing for the remainder of the July through September quarter and the October through December quarter (see attached).

A brief discussion followed the Chairman's presentation but did not raise significant questions regarding the report's content.

The meeting adjourned at 6:20 p.m.

Karthik Ramanathan, Director
Office of Debt Management, United States Department of the Treasury
July 29, 2008

Certified by:

Keith T. Anderson, Chairman
Treasury Borrowing Advisory Committee
Of The Securities Industry and Financial Markets Association
July 29, 2008

Treasury Borrowing Advisory Committee Quarterly Meeting
Committee Charge – July 29, 2008

Fiscal Outlook

Given Treasury's financing needs in the coming years as well as current and medium-term trends in the economic outlook, what are the Committee's thoughts on Treasury's debt issuance? In particular, we would like the Committee's advice on whether the recent adjustments to the financing schedule provide Treasury with sufficient debt management tools to handle a wide range of budgetary and financing outcomes, or if additional adjustments should be considered.

Credit Market Conditions

Treasury seeks the Committee's perspectives on the current conditions of credit markets. What are investors' perceptions of risk in light of previous actions by the Federal Reserve, including its introduction of various temporary facilities such as the Term Securities Lending Facility and the Primary Dealer Credit Facility, and additional recent initiatives by the Treasury and Federal Reserve? What are the implications for financial market investors, regulatory oversight, and market infrastructure, as well as their potential impact on Treasury market dynamics?

TIPS and Inflation Trends

In light of recent trends, Treasury would like the Committee's views on TIPS, particularly in regard to issuance of shorter-dated versus longer-dated inflation-indexed securities.

Financing this Quarter

We would like the Committee's advice on the following:

- The composition of Treasury notes and bonds to refund approximately

$43.5 billion of privately held notes maturing on August 15, 2008.

- The composition of Treasury marketable financing for the remainder of the July-September quarter, including cash management bills.
- The composition of Treasury marketable financing for the October-December quarter, including cash management bills.

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July 31, 2008
HP-1096

Treasury Targets FARC Financiers and Drug-Traffickers

Washington, DC--The U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) today designated six companies and 13 individuals that act on behalf of and materially assist the narcotics trafficking activities of the Revolutionary Armed Forces of Colombia (FARC), a designated narco-terrorist organization. Today's designation, made pursuant to the Foreign Narcotics Kingpin Designation Act (Kingpin Act), is OFAC's fifth action against the FARC in the past eight months.

"Today's action is the latest in a series of blows to the FARC and builds on the Colombian government's recent successes against this corrupt narco-terrorist group," said OFAC Director Adam J. Szubin. "Our designation targets the logistical and financial support network of the FARC's 1st Front, the arm of this terrorist group responsible for holding the hostages recently rescued by the Colombian authorities."

One of the FARC individuals sanctioned today, Alexander Farfan Suarez (a.k.a. "Enrique Gafas"), was captured by Colombian authorities during the July 2, 2008 hostage rescue mission that freed three U.S. citizens--Marc Gonsalves, Thomas Howes, and Keith Stansell--who were held captive roughly five years, as well as 12 other hostages held by the FARC. Also captured was the FARC's 1st Front commander, Gerardo Antonio Aguilar Ramirez (a.k.a. "Cesar"), who was designated by OFAC on September 28, 2006.

This OFAC sanctions investigation targets a logistical and financial support network of the FARC's 1st Front, run by Nancy Conde Rubio (a.k.a. "Doris Adriana"). Conde Rubio, arrested by Colombian authorities in February 2008, oversaw individuals and entities that used money derived from FARC narcotics sales to procure weapons, ammunition, communications gear, medical equipment, uniforms, and airplane fuel. Conde Rubio communicated with various persons in the FARC network targeted by this action using *Communicaciones Unidas de Colombia Ltda.*, a call center located in Villavicencio, Colombia, operated by FARC associate Ana Isabel Pena Arevalo. This FARC network laundered its drug trafficking monies through two money exchange businesses or *cambistas* - *Cambios Euro Ltda.* and *La Monedita De Oro Ltda.* - both located in Bogota, Colombia. Two other Bogota-based FARC front companies, *Dizriver Y Cia S. En C.* and *Colchones Sunmoons Ltda.*, were also designated.

Conde Rubio and eight other individuals sanctioned by OFAC today were named in a February 2008 U.S. federal indictment in the U.S. District Court for the District of Columbia for materially assisting the FARC.

Also designated today is Jose Maria Corredor Ibague (a.k.a. "Boyaco"), considered one of the FARC's most prolific arms-for-drugs traffickers of the past few years. Josue Cuesta Leon (a.k.a. "El Viejo") and Edilma Morales Loaiza, both key arms traffickers involved in the FARC's drug trafficking activities, were also named.

OFAC's sanctions investigation of the FARC's 1st Front would not have been possible without the support of the Federal Bureau of Investigation and the U.S. Attorney's Office for the District of Columbia.

In addition, *Exchange Center Ltda.*, a Colombian *cambista* linked to the FARC's 27th Front is being designated by OFAC today. Previously, on May 7, 2008, OFAC designated *Mercurio International S.A.*, a Colombian money exchange house ("*casa de cambio*") for providing support to the FARC.

On May 29, 2003, President George W. Bush identified the FARC as a significant foreign narcotics trafficker pursuant to the Kingpin Act. Previously, in 2001, OFAC designated the FARC as a Specially Designated Global Terrorist pursuant to Executive Order 13224, and in 1997 the FARC was designated as a Foreign Terrorist Organization by the Secretary of State.

Today's action freezes any assets the designated entities and individuals may have under U.S. jurisdiction and prohibits U.S. persons from conducting financial or commercial transactions involving those assets. Penalties for violations of the Kingpin Act range from civil penalties of up to $1,075,000 per violation to more severe criminal penalties. Criminal penalties for corporate officers may include up to 30 years in prison and fines of up to $5,000,000. Criminal fines for corporations may reach $10,000,000. Other individuals face up to 10 years in prison for criminal violations of the Kingpin Act and fines pursuant to Title 18 of the United States Code.

For a complete list of the individuals and entities designated today, please visit: http://www.treasury.gov/offices/enforcement/ofac/actions/

To view previous OFAC actions directed against the FARC, please visit:

- Treasury Action against the FARC on May 7, 2008
- Treasury Action against the FARC on April 22, 2008.
- Treasury Action against the FARC on January 15, 2008
- Treasury Action against the FARC on November 1, 2007
- Treasury Action against the FARC on September 28, 2006
- Treasury Action against the FARC on February 19, 2004.

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REPORTS

- Chart

July 25, 2008
HP-1097

Treasury Designates Zimbabwean Parastatals and Companies Supporting the Mugabe Regime

Washington, DC--The U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) today designated seventeen entities, including several Zimbabwean parastatals, and one individual whose support for Robert Mugabe's regime contributes to the undermining of democratic processes and institutions in Zimbabwe.

"In light of the continued intransigence of the brutal Mugabe regime, the U.S. is imposing further sanctions against this regime and its supporters," said OFAC Director Adam J. Szubin. "These actions send a clear warning to those who would protect Mugabe and his assets at the expense of the Zimbabwean people."

Today's designations include a number of Zimbabwean parastatals and entities that are owned or controlled by the Government of Zimbabwe. Robert Mugabe, his senior officials, and regime cronies have used these entities to illegally siphon revenue and foreign exchange from the Zimbabwean people. Treasury's designations today include the Minerals Marketing Corporation of Zimbabwe (a.k.a MMCZ), the sole marketing and export agent for all minerals, except gold and silver, mined in Zimbabwe; the Zimbabwe Mining Development Corporation (a.k.a. ZMDC), involved in investment in the mining industry in Zimbabwe, and in planning, coordinating and implementing mining projects on behalf of the Government of Zimbabwe; the Zimbabwe Iron and Steel Company (a.k.a. ZISCO), Zimbabwe's largest steel works; the Agricultural Development Bank of Zimbabwe (a.k.a Agribank), a commercial bank owned by the Government of Zimbabwe; the Industrial Development Corporation of Zimbabwe Ltd, a state-owned enterprise that owns a large number of companies operating in the industrial sector, including the chemical, clothing and textiles, mineral processing, and motor and transport sectors; the Infrastructure Development Bank of Zimbabwe, a financing entity; Zimre Holdings Limited, an investment and reinsurance entity; ZB Financial Holdings Limited, a holding company for a group of companies involved in commercial and merchant banking; and 4 major subsidiaries of ZB Financial Holdings Limited: ZB Bank Limited (a.k.a Zimbank), ZB Holdings Limited, Intermarket Holdings Limited, and Scotfin Limited.

Also designated today are Thamer Bin Saeed Ahmed Al-Shanfari, an Omani national with close ties to Mugabe and his top officials, as well as his company, Oryx Natural Resources, which Al-Shanfari uses to enable Mugabe and his senior officials to maintain access to, and derive personal benefit from, various mining ventures in the Democratic Republic of the Congo (the "DRC"). OFAC has also designated OSLEG (a.k.a. Operation Sovereign Legitimacy), an enterprise that is a commercial arm of the Zimbabwean army representing its interests in the DRC and elsewhere, and which is controlled by various senior officials in Zimbabwe. The activities of OSLEG and Al-Shanfari's Oryx Natural Resources, benefiting Robert Mugabe and his regime's senior officials, have been widely documented by various non-governmental and human rights organizations.

Finally, OFAC is designating the following companies that are owned or controlled by a number of Specially Designated Nationals ("SDNs"): Divine Homes, a property company whose Chairman is SDN David Chapfika, Zimbabwe's Deputy Minister of Agriculture; COMOIL (Pvt) Ltd., a petroleum importing company, owned by SDN Saviour Kasukuwere, Zimbabwe's Deputy Minister of Youth Development and Employment Creation; and Famba Safaris, a registered Zimbabwean safari operator, whose Director and major shareholder is SDN Webster Shamu, Mugabe's Minister of State for Policy Implementation.

As a result of Treasury's action, any assets of the individual and entities designated today that are within U.S. jurisdiction must be frozen. Additionally, U.S. persons are

prohibited from conducting financial or commercial transactions with the individual or entities.

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REPORTS

- Statement by the President
- Executive Order

THE WHITE HOUSE

For Immediate Release
Office of the Press Secretary
July 25, 2008

Executive Order: Blocking Property of Additional Persons Undermining Democratic Processes or Institutions in Zimbabwe

By the authority vested in me as President by the Constitution and the laws of the United States of America, including the International Emergency Economic Powers Act (50 U.S.C. 1701 et seq.) (IEEPA), the National Emergencies Act (50 U.S.C. 1601 et seq.), and section 301 of title 3, United States Code,

I, GEORGE W. BUSH, President of the United States of America, find that the continued actions and policies of the Government of Zimbabwe and other persons to undermine Zimbabwe's democratic processes or institutions, manifested most recently in the fundamentally undemocratic election held on June 27, 2008, to commit acts of violence and other human rights abuses against political opponents, and to engage in public corruption, including by misusing public authority, constitute an unusual and extraordinary threat to the foreign policy of the United States, and to deal with that threat, hereby expand the scope of the national emergency declared in Executive Order 13288 of March 6, 2003, and relied upon for additional steps taken in Executive Order 13391 of November 22, 2005, and hereby order:

Section 1. (a) Except to the extent provided by statutes, or provided in regulations, orders, directives, or licenses that may be issued pursuant to this order, and notwithstanding any contract entered into or any license or permit granted prior to the date of this order, all property and interests in property that are in the United States, that hereafter come within the United States, or that are or hereafter come within the possession or control of United States persons, including their overseas branches, of the following persons are blocked and may not be transferred, paid, exported, withdrawn, or otherwise dealt in:

Any person determined by the Secretary of the Treasury, after consultation with the Secretary of State:

(i) to be a senior official of the Government of Zimbabwe;

(ii) to be owned or controlled by, directly or indirectly, the Government of Zimbabwe or an official or officials of the Government of Zimbabwe;

(iii) to have engaged in actions or policies to undermine Zimbabwe's democratic processes or institutions;

(iv) to be responsible for, or to have participated in, human rights abuses related to political repression in Zimbabwe;

(v) to be engaged in, or to have engaged in, activities facilitating public corruption by senior officials of the Government of Zimbabwe;

vi) to be a spouse or dependent child of any person whose property and interests in property are blocked pursuant to Executive Order 13288, Executive Order 13391, or this order;

vii) to have materially assisted, sponsored, or provided financial, material, logistical, or technical support for, or goods or services in support of, the Government of Zimbabwe, any senior official thereof, or any person whose property and interests in property are blocked pursuant to Executive Order 13288, Executive Order 13391, or this order; or

ii) to be owned or controlled by, or to have acted or purported to act for or on behalf of, directly indirectly, any person whose property and interests in property are blocked pursuant to Executive Order 13288, Executive Order 13391, or this order.

) I hereby determine that the making of donations of the type of articles specified in section 203)(2) of IEEPA (50 U.S.C. 1702(b)(2)) by, to, or for the benefit of any person whose property and iterests in property are blocked pursuant to paragraph (a) of this section would seriously impair y ability to deal with the national emergency declared in Executive Order 13288, as amended, nd I hereby prohibit such donations as provided by paragraph (a) of this section.

c) The prohibitions of this section include but are not limited to (i) the making of any contribution r provision of funds, goods, or services by, to, or for the benefit of any person whose property and iterests in property are blocked pursuant to Executive Order 13288, Executive Order 13391, or his order, and (ii) the receipt of any contribution or provision of funds, goods, or services from any uch person.

d) The provisions of Executive Orders 13288 and 13391 remain in effect, and this order does not ffect any action taken pursuant to those orders.

Sec. 2. (a) Any transaction by a United States person or within the United States that evades or voids, has the purpose of evading or avoiding, or attempts to violate any of the prohibitions set orth in this order is prohibited.

(b) Any conspiracy formed to violate any of the prohibitions set forth in this order is prohibited.

Sec. 3. For the purposes of this order:

(a) the term "person" means an individual or entity;

(b) the term "entity" means a partnership, association, trust, joint venture, corporation, group, subgroup, or other organization;

(c) the term "United States person" means any United States citizen, permanent resident alien, entity organized under the laws of the United States or any jurisdiction within the United States (including foreign branches), or any person in the United States; and

(d) the term "Government of Zimbabwe" means the Government of Zimbabwe, its agencies, instrumentalities, and controlled entities.

Sec. 4. For those persons whose property and interests in property are blocked pursuant to this order who might have a constitutional presence in the United States, I find that, because of the ability to transfer funds or other assets instantaneously, prior notice to such persons of measures to be taken pursuant to this order would render these measures ineffectual. I therefore determine that, for these measures to be effective in addressing the national emergency declared in Executive Order 13288, there need be no prior notice of a listing or determination made pursuant to section 1

of this order.

Sec. 5. The Secretary of the Treasury, after consultation with the Secretary of State, is hereby authorized to take such actions, including the promulgation of rules and regulations, and to employ all powers granted to the President by IEEPA as may be necessary to carry out the purposes of this order. The Secretary of the Treasury may redelegate any of these functions to other officers and agencies of the United States Government consistent with applicable law. All agencies of the United States Government are hereby directed to take all appropriate measures within their authority to carry out the provisions of this order.

Sec. 6. The Secretary of the Treasury, after consultation with the Secretary of State, is hereby authorized to submit the recurring and final reports to the Congress on the national emergency declared in Executive Order 13288, as amended, and expanded in this order, consistent with section 401(c) of the NEA (50 U.S.C. 1641(c)) and section 204(c) of IEEPA (50 U.S.C. 1703).

Sec. 7. This order is not intended to, and does not, create any right or benefit, substantive or procedural, enforceable at law or in equity by any party against the United States, its departments, agencies, instrumentalities, or entities, its officers or employees, or any other person.

GEORGE W. BUSH

THE WHITE HOUSE,

July 25, 2008.

# # #

July 26, 2008
HP-1098

**Statement by Secretary Henry M. Paulson, Jr.
on Senate Passage of GSE Bill**

Washington - *Treasury Secretary Henry M. Paulson, Jr. issued the following statement today on Senate passage of the GSE bill:*

"I commend the Senate for moving swiftly to pass important GSE legislation that will provide temporary authorities to give confidence to markets and will create a strong, independent regulator better able to address the risks these enterprises pose.

"As the President has said, we are disappointed that the legislation includes extraneous provisions that can hinder our efforts to get through the housing correction quickly.

"But it is of the utmost importance to our market and economic stability that the GSE portions of this bill become law. These components are orders of magnitude more important to turning the corner on the housing correction."

-30-

July 28, 2008
HP-1099

Treasury to Hold Mortgage Finance Press Conference

Secretary Henry M. Paulson, Jr. will hold a press conference on mortgage finance today at the Treasury Department. The Secretary will join financial regulators and future covered bond issuers to announce a guide for the development of a covered bond market in the United States.

Treasury and FDIC officials and a representative from the covered bond market will hold an off-camera background briefing following the press conference. The following events are open to the media:

Who
Secretary Henry M. Paulson, Jr.
What
Press Conference
When
Monday, July 28, 2:30 p.m. EDT
Where
Treasury Department
Media Room (4121)
1500 Pennsylvania Avenue, NW
Washington, D.C.
Note
Media without Treasury press credentials should contact Frances Anderson at (202) 622-2960 or frances.anderson@do.treas.gov with the following information: full name, Social Security number, and date of birth.

*****

What
Pen and Pad Background Briefing
When
Monday, July 28, 3:00 p.m. EDT
Where
Treasury Department
West Gable Room (5432)
1500 Pennsylvania Avenue, NW
Washington, D.C.
Note
Media without Treasury press credentials should contact Frances Anderson at (202) 622-2960 or frances.anderson@do.treas.gov with the following information: full name, Social Security number, and date of birth. No cameras will be allowed into the background briefing.

July 28, 2008
HP-1100

Treasury Assistant Secretary Swagel to Hold Monthly Economic Briefing

U.S. Treasury Assistant Secretary for Economic Policy Phillip Swagel will hold a media briefing to review economic indicators from the last month as well as discuss the state of the U.S. Economy. The event is open to the media:

Who
Assistant Secretary for Economic Policy Phillip Swagel

What
Economic Media Briefing

When
Friday, August 1, 11:00 a.m. EDT

Where
Treasury Department
Media Room (4121)
1500 Pennsylvania Avenue, NW
Washington, D.C.

Note
Media without Treasury press credentials should contact Frances Anderson at (202) 622-2960, or Frances.Anderson@do.treas.gov with the following information: full name, Social Security number, and date of birth.

July 28, 2008
HP-1100

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July 28, 2008
HP-1101

Secretary Henry M. Paulson, Jr.
Statement on Covered Bond Best Practices

Washington - Good afternoon. Thank you all for coming today. Joining me on stage are FDIC Chairman Sheila Bair, Federal Reserve Governor Kevin Warsh, OCC Comptroller John Dugan and OTS Director John Reich. We also welcome representatives from Bank of America, Citigroup, JP Morgan Chase, and Wells Fargo. I will make a few remarks, my colleagues will also address you and then Jeff Brown with Bank of America will speak.

As we are all aware, the availability of affordable mortgage financing is essential to turning the corner on the current housing correction. And so we have been looking broadly for ways to increase the availability and lower the cost of mortgage financing to accelerate the return of normal home buying and refinancing activity.

The housing government-sponsored enterprises, Fannie Mae, Freddie Mac and the Federal Home Loan Banks, and the Federal Housing Administration are funding more than 70 percent of residential mortgages during these months of market stress. They must continue to be active here.

At the same time, private-label securitization, another important source of mortgage finance, has become severely strained and credit conditions have tightened. In addition to securitization done by housing GSEs, private mortgage-backed securitization benefits the American consumer and our markets. The private-label market will evolve in response to current challenges, and I expect it to return with greater risk-awareness and investor discipline. We also believe it is useful to explore additional mortgage financing options to complement more traditional funding models.

One option we have looked at extensively is covered bonds, which are a $3 trillion market used widely in Europe for mortgage funding. I believe covered bonds have the potential to increase mortgage financing, improve underwriting standards, and strengthen U.S. financial institutions by providing a new funding source that will diversify their overall portfolio.

Treasury has been working with our regulatory counterparts to look at ways to support the emergence of the covered bond market in the United States. We consulted with our European counterparts, including the UK Treasury. We also spoke with potential U.S. market participants, including issuers, investors, underwriters and ratings agencies. While many European countries have dedicated covered bond legislation, the U.S. regulatory environment is different. Covered bonds are a promising financing vehicle and we believe this market can grow in the United States absent federal legislative action.

To help achieve our goal of broader choices in mortgage finance, today Treasury is publishing a Best Practices guide for U.S. residential covered bonds. This document is intended to outline practices that will promote covered bond market simplicity and homogeneity, using high quality mortgages as collateral. It is a starting point and complements the FDIC final policy statement of July 15th.

I appreciate the FDIC's strong leadership in advocating covered bonds and providing clarity to potential investors. Together, the FDIC final policy statement and a Treasury Best Practices guide should give market participants the tools to build a market that will benefit U.S. families and the U.S. economy. A U.S. covered bond market also will present new opportunities for further international investment in the United States.

We knew that this initiative would be successful only if the largest banks paved the way. And so I welcome the announcement by America's four largest banks, Bank of America, Citigroup, JPMorgan Chase and Wells Fargo, that they intend to establish covered bond programs and kick-start this market in the United States. And, I am also pleased to know that the two existing domestic issuers of covered bonds intend to align their programs with these new practices.

We applaud these banks for their leadership and for recognizing an opportunity to help increase mortgage funding availability and strengthen our financial system. We are at the early stages of what should be a promising path, where the nascent U.S. covered bond market can grow and provide a new source of mortgage financing.

Covered bonds are simply one tool for mortgage financing and will not, alone, complete the housing correction. We will continue to pursue our efforts to avoid preventable foreclosures and to speed, without impeding, the necessary course of this housing correction. Thank you and now Chairman Bair will say a few words.

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July 28, 2008
HP-1102

Treasury Releases Best Practices to Encourage Additional Form of Mortgage Finance

Washington- The U.S. Treasury Department took steps today to encourage additional sources of mortgage finance and strengthen financial institutions by issuing Best Practices for Residential Covered Bonds.

"As we are all aware, the availability of affordable mortgage financing is essential to turning the corner on the current housing correction. And so we have been looking broadly for ways to increase the availability and lower the cost of mortgage financing to accelerate the return of normal home buying and refinancing activity," said Treasury Secretary Henry M. Paulson, Jr. "We are at the early stages of what should be a promising path, where the nascent U.S. covered bond market can grow and provide a new source of mortgage financing."

A covered bond is secured debt instrument that provides funding to a depository institution, collateralized by high-quality mortgage loans that remain on the issuer's balance sheet. Covered bonds have the potential to increase funding for mortgages and to strengthen our financial institutions by offering them a new funding source that will diversify their overall funding portfolio.

While a large European covered bond market already exists, valued at $3.3 trillion in 2007, only two U.S. institutions to date have issued covered bonds. Market participants sought structural clarity to develop the U.S. covered bond market.

This document is intended to provide clarity and homogeneity to the new market. It is meant to define a starting point for the U.S. covered bond market and serve as a complement to the Federal Deposit Insurance Corporation final policy statement.

Treasury worked with the FDIC, the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision and the Securities and Exchange Commission when developing the guide. The Department also consulted with market participants, including potential issuers, investors, underwriters, ratings agencies as well as international regulators.

Treasury believes the $11 trillion mortgage market can benefit from all forms of mortgage finance. Covered bonds can serve as a complement to the housing government sponsored enterprises, helping to provide additional funding to homeowners.

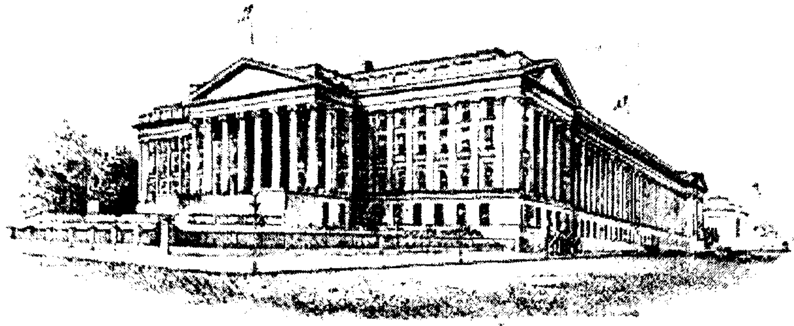
Secretary Paulson first discussed Treasury's interest in helping to develop covered bond guidance in March 2008. The initiative is one of many options Secretary Paulson has pursued to help stabilize the mortgage finance market, including regulatory reform of the government sponsored enterprises, FHA modernization and the creation of HOPE NOW, a coalition of mortgage servicers, lenders and counselors that aims to reach more troubled borrowers.

In conjunction with the release of the Best Practices Guide, Treasury will update its own collateral acceptability policy to include covered bonds as an approved asset category for securing the Treasury's investments and deposits of public money with commercial counterparties.

-30-

REPORTS

- Fact Sheet
- US Covered Bond Best Practices
- More Information



U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 2:30 p.m. (EDT), July 28, 2008
CONTACT Jennifer Zuccarelli, (202) 622-8657

FACT SHEET: TREASURY RELEASES BEST PRACTICES FOR RESIDENTIAL COVERED BONDS

"As we are all aware, the availability of affordable mortgage financing is essential to turning the corner on the current housing correction. And so we have been looking broadly for ways to increase the availability and lower the cost of mortgage financing to accelerate the return of normal home buying and refinancing activity. We are at the early stages of what should be a promising path, where the nascent U.S. covered bond market can grow and provide a new source of mortgage financing."

\- Treasury Secretary Henry M. Paulson, Jr.

- The Administration is focused on pursuing a range of initiatives to help homeowners avoid preventable foreclosures and to speed the recovery from the housing correction. Covered bonds have the potential to help homebuyers and those seeking to refinance by increasing mortgage financing. Covered bonds can also help strengthen U.S. financial institutions by providing a new funding source that will diversify their overall funding portfolio.

- Treasury today issued Best Practices for Residential Covered Bonds in response to market participants' request for clarity from regulators regarding the covered bond market. A robust covered bond market exists in Europe, and in preparing this Best Practices Guide, Treasury consulted with our European counterparts as well as with potential U.S. market participants, including issuers, investors, underwriters and rating agencies.

- While in Europe specific legislation often defines the debt instrument, the U.S. regulatory environment is different and does not require legislation.

- On July 15, 2008, the Federal Deposit Insurance Corporation issued a Final Covered Bond Policy Statement which specified actions that the FDIC will take during an insolvency or receivership if the covered bond meets certain minimum requirements. The Best Practices Guide is a complement to the FDIC statement because it introduces standards in areas such as collateral and disclosure that will help to start the covered bond market with very high quality securities. Treasury and the FDIC issued their guides to bring clarification on these issues.

- The Treasury Department believes that there should be a variety of financing alternatives within the U.S. mortgage market. The housing government-sponsored enterprises, Fannie Mae, Freddie Mac and the Federal Home Loan Banks, and the Federal Housing Administration are fulfilling their public policy missions by providing mortgage financing during these months of market stress. They must continue to do so. Treasury also expects private-label securitization to return

to the U.S. mortgage market, enabling homeowners to benefit from a broad, global investor base. Given the size of the U.S. residential mortgage market, Treasury believes there will be a role for all sources of mortgage funding in the future.

- A covered bond is a secured debt instrument that provides funding to a depository institution, or issuer, that retains residential mortgage assets and related credit risk on its balance sheet. These assets are known as the cover pool. Interest on the covered bond is paid to investors from the issuer's cash flows, while the cover pool serves as secured collateral. Covered bonds provide dual recourse to both the cover pool and the issuer. In the event of an issuer default, covered bond investors first have recourse to the cover pool. In the event the cover pool returns less than par in a liquidation, investors maintain an unsecured claim on the issuer.

- Covered bonds differ from mortgage backed securities in several ways. First, mortgages securing covered bonds remain on an issuer's balance sheet, unlike mortgage backed securities. Second, pools of loans securing covered bonds are dynamic, and non-performing or prepaying loans must be substituted out of the cover pool. Finally, if a covered bond accelerates and repays investors at an amount less than the principal and interest owed, investors retain an unsecured claim on the issuer.

- Covered bonds differ from unsecured debt because of the absence of secured collateral underlying the obligation of the issuer. While unsecured debt investors retain an unsecured claim on the issuer in the event of issuer default, covered bond investors possess dual recourse to both the underlying collateral of a covered bond and to the individual issuer. Accordingly, covered bonds provide investors with additional protection on their investment compared with unsecured debt.

- In conjunction with the release of this Best Practices Guide, Treasury will update its own collateral acceptability policy to include covered bonds as an approved asset category for securing the Treasury's investments and deposits of public money with commercial counterparties.

SUMMARY OF BEST PRACTICES

To be consistent with Treasury's Best Practices, a covered bond program must conform to all the provisions throughout the life of the program. The following is a summary of key provisions found in the Best Practices Guide. A complete description of all provisions can be found in the document.

Issuer

- The Issuer may be either:
  - A newly created, bankruptcy-remote special purpose vehicle; or
  - A depository institution and/or wholly-owned subsidiary of a depository institution

Security

- In both the special purpose vehicle structure and the direct issuance structure, the cover pool must be owned by the depository institution. Issuers must provide first priority claim on the assets to bond holders and the assets in the cover pool must not be burdened by other liens. The cover pool's assets and liabilities must be clearly identified on its books and records.

Maturity

- The maturity for covered bonds shall be greater than one year and no more than 30 years.

Eligible Cover Pool Collateral

- Collateral in the cover pool must meet certain requirements at all times to be eligible. The template outline the complete criteria for eligible mortgages which includes, but is not limited to:
  - One-to-four family residential properties
  - Underwritten at the fully-indexed rate
  - Underwritten with documented income
  - Current when they are added to the pool and any mortgages that become more than 60-days past due must be replaced
  - First lien only
  - Maximum loan-to-value of 80 percent at the time of inclusion in the cover pool
  - Negative amortization are not eligible for the cover pool

Overcollateralization

- Issuers must maintain an overcollateralization value at all times of at least 5 percent of the outstanding principal balance of the covered bonds.

Specified Investment Contract

- Each covered bond must have a specified investment to prevent an acceleration of the covered bond due to the insolvency of the Issuer.

Cover Pool Disclosure

- Issuers must make available descriptive information on the cover pool with investors at the time an investment decision is being made and on a monthly basis after issuance. The SEC's

Regulation AB provides a helpful template for preparing pool level information, such as presenting summary information in tabular or graphical format and using appropriate groups or ranges

Issuers must make this information available to investors no later than 30 days after the end of each month.

Asset Coverage Test

- The Issuer must perform an asset coverage test on a monthly basis to ensure collateral quality and the proper level of overcollateralization and to make any substitutions that are necessary to meet the provisions of the Template. The results of this asset coverage test and the results of any reviews by the asset monitor must be made available to investors.

Regulatory Authorization

- Issuers must receive consent to issue covered bonds from their primary federal regulator.

Issuance Limitations

- Covered bonds may account for no more than 4 percent of an issuers' liabilities after issuance.

BEST PRACTICES FOR RESIDENTIAL COVERED BONDS

THE DEPARTMENT OF THE TREASURY

UNITED STATES DEPARTMENT OF THE TREASURY
BEST PRACTICES FOR RESIDENTIAL COVERED BONDS

July 2008

Henry M. Paulson, Jr.
Secretary of the Treasury

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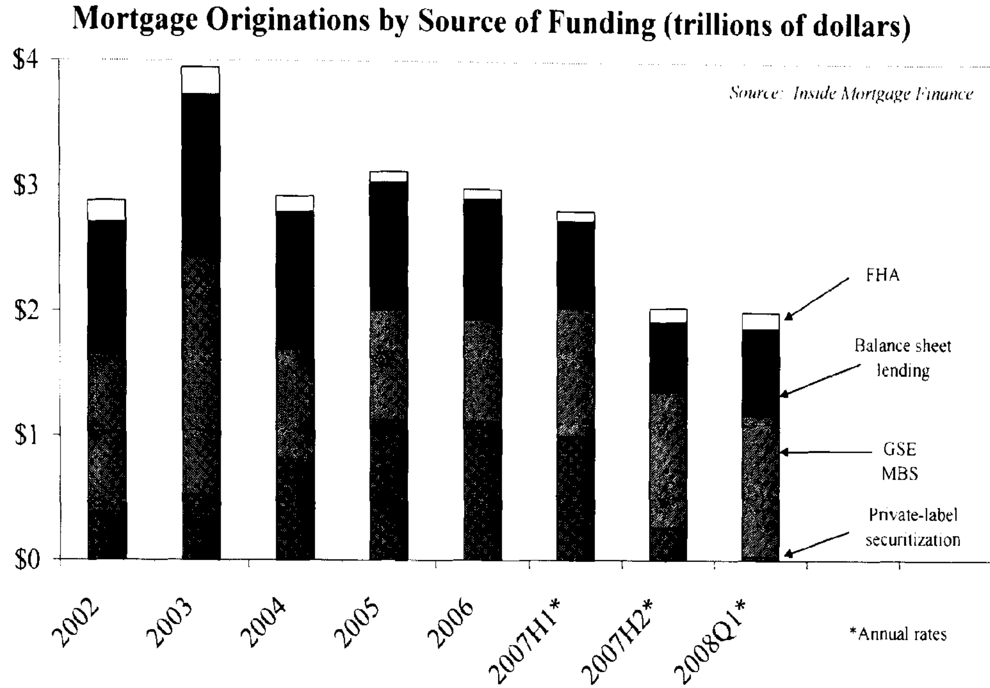
I. Background

This Best Practices guide has been prepared by the Department of the Treasury ("Treasury") in order to encourage the growth of the Covered Bond market in the United States. Treasury believes that Covered Bonds represent a potential additional source of financing that could reduce borrowing costs for homeowners, improve liquidity in the residential mortgage market, and help depository institutions strengthen their balance sheets by diversifying their funding sources.

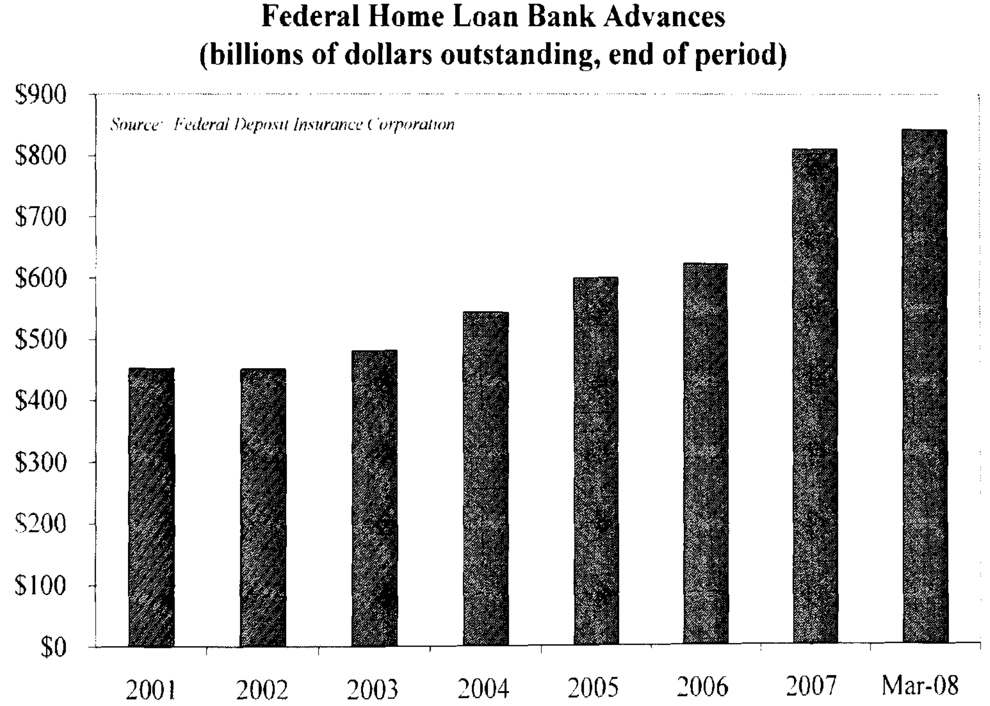
U.S. depository institutions have historically utilized several different funding sources to originate new residential mortgage loans, both for sale to investors and for their own portfolios. For loans sold into the market, depository institutions' funding options included selling the loans directly to investors, Fannie Mae, or Freddie Mac, and via private-label securitization. For loans retained on their balance sheets, depository institutions' funding options included utilizing their customers' deposits, issuing unsecured debt, and pledging their mortgages as collateral for advances from the Federal Home Loan Banks.

Recent market turmoil has severely limited the ability of depository institutions to sell loans to investors via private-label securitization. Consistent with their important public policy mission, the government-sponsored enterprises, Fannie Mae, Freddie Mac and the Federal Home Loans Banks, as well as the Federal Housing Administration have been playing a critical role by providing mortgage finance during this strained period. Even so, many depository institutions are keeping more mortgage loans on their balance sheets and are therefore seeking new sources of on-balance sheet financing. Many U.S. depository institutions are examining the potential of Covered Bonds to provide this financing while at the same time diversifying their overall funding portfolio.

Private-label securitization has become strained. The GSEs, FHA and balance sheet lending have expanded in response. Nonetheless, total mortgage originations have fallen.

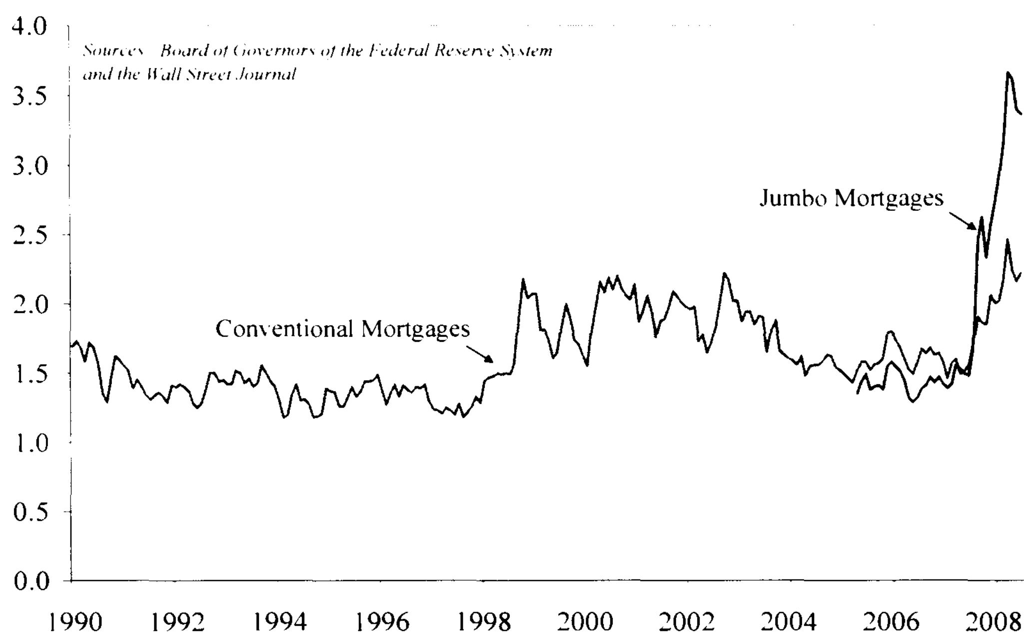


The Federal Home Loan Banks are playing an important and expanded role funding lenders' balance sheets.



Even with the expanded roles of Fannie Mae, Freddie Mac, the Federal Home Loan Banks and the Federal Housing Administration, mortgage spreads are increasing for all classes of mortgage loans.

Mortgage Rate Spreads to 10-Year Treasury (percent)



Covered Bonds present an alternative source of funding for institutions that can complement other sources of financing for a wide range of high-quality assets. In Europe, Covered Bonds are highly liquid instruments which are typically sold to rate-product investors rather than credit-product investors. While a Covered Bond market is already well-established in Europe, to date only two U.S. depository institutions have issued Covered Bonds. Given current challenges in other financing markets, U.S. institutions may find Covered Bonds to be an attractive source of funding for mortgage loans.

Treasury expects private-label securitization to return to the U.S. mortgage market, enabling homeowners to benefit from a broad, global investor base. Given the size of the U.S. residential mortgage market, Treasury believes there will be a role for all sources of mortgage funding in the future.

II. Objective

In preparing this report, Treasury seeks to bring increased clarity and homogeneity to the United States Covered Bond market by developing a series of Best Practices. Although the United States does not have dedicated Covered Bond legislation, Treasury believes these Best Practices may serve as a starting-point for the market, by encouraging issuers to use a common and simplified structure with high quality collateral for Covered Bond issuances. However, this document does not imply that Treasury favors Covered Bonds over other financing options available to depository institutions. Instead, Treasury views Covered Bonds as an additional, complementary funding source for the $11 trillion residential mortgage market.

Treasury has limited these Best Practices specifically to Covered Bonds backed by collateral consisting of high quality residential mortgage loans for two reasons. First, a liquid Covered Bond market based on residential mortgages may provide additional funding for the housing market, in turn lowering mortgage rates for homeowners. Second, focusing on one type of collateral while the market is nascent will provide simplicity for market participants. However, Treasury expects that the Covered Bond market to develop over time and the collateral securing Covered Bonds may eventually include other asset classes.

It should be noted that these Best Practices serve as a complement to the Federal Deposit Insurance Corporation's *Final Covered Bond Policy Statement* dated July 15, 2008 (see Appendix B). This statement specifies actions that the FDIC will take during an insolvency or receivership if the Covered Bond meets certain minimum requirements.

Finally, while these Best Practices have been developed to facilitate the growth of the Covered Bond market, they should not constrain the market in the future. Treasury fully expects the structure, collateral and other key terms of Covered Bonds to evolve with the growth of this market in the United States.

In preparing this Best Practices document, Treasury discussed the potential development of the U.S. Covered Bond market with both U.S. and European regulators, as well as numerous market participants, including potential issuers, investors, underwriters, rating agencies, law firms, financial counterparties, service providers and trade associations.

III. Covered Bond Definition

For the purposes of this document, a Covered Bond is defined as follows:

A Covered Bond is a debt instrument secured by a perfected security interest in a specific pool of collateral ("Cover Pool"). A Covered Bond provides funding to a depository institution ("issuer") that retains a Cover Pool of residential mortgage assets and related credit risk on its balance sheet. Interest on the Covered Bond is paid to investors from the issuer's general cash flows, while the Cover Pool serves as secured collateral. This Cover Pool consists of a portfolio of performing residential mortgage loans that meet specified underwriting criteria and are actively managed by the issuer to meet certain characteristics. If assets within the Cover Pool become non-performing, they must be replaced with performing assets. Finally, the issuer must maintain a Cover Pool in excess of the notional value of the Covered Bond ("overcollateralization") at all times. Multiple issuances for a depository institution may utilize a common Cover Pool.

In the event of an issuer default, Covered Bond investors first have recourse to the Cover Pool. In the event the Cover Pool returns less than par in liquidation, investors retain an unsecured claim on the issuer ranking pari passu with other unsecured creditors. Hence, Covered Bonds provide dual recourse to both the Cover Pool and the issuer, and the overcollateralization of the Cover Pool helps to mitigate the risk that investors would receive less than par in the event of an issuer default.

Comparison to Unsecured Debt

Unsecured debt differs significantly from Covered Bonds because of the absence of secured collateral underlying the obligation of the issuer. While unsecured debt investors retain an unsecured claim on the issuer in the event of issuer default, Covered Bond investors possess dual recourse to both the underlying collateral of a Covered Bond and to the individual issuer. Accordingly, Covered Bonds provide investors with additional protection on their investment compared with unsecured debt.

Comparison to Mortgage-Backed Securities

Although both mortgage-backed securities ("MBS") and Covered Bonds are a potential source of long-term funding for residential mortgage loans, there are several essential differences between Covered Bonds and MBS that make each attractive to different types of investors:

- Mortgages that secure a Covered Bond remain on the issuer's balance sheet, unlike MBS where mortgages are packaged and sold to investors.

- The cash flow from the mortgages and credit enhancements in MBS are generally the only source of principal and interest payments to the MBS investors. In a Covered Bond, principal and interest are paid by the issuer's cash flows, while the mortgages in the Cover Pool only serve as collateral for investors.

- The collateral underlying Covered Bonds is dynamic and non-performing (or prepaying) assets within the Cover Pool must be substituted with performing mortgages. Mortgages underlying MBS are static and remain in each MBS until maturity.

- In the case of an issuer default, Covered Bonds are structured to avoid prepayment prior to the date of maturity. This is accomplished through swap agreements and deposit agreements (e.g., guaranteed investment contracts). MBS investors, in contrast, are exposed to prepayment risk in the case of a mortgage default or prepayment.

- In the event that the Covered Bonds do accelerate and repay investors at an amount less than the principal and accrued interest, investors retain an unsecured claim on the issuer. MBS investors generally do not retain any claim on the issuer in the event of repayment at an amount less than the principal and interest owed.

IV. History of the Covered Bond Market

The Covered Bond market has a long and extensive history in Europe, dating back more than 230 years to the initial Prussian issuance in 1770. Covered Bonds were initially used to finance agriculture and later became focused on residential and commercial real estate markets. While Covered Bonds remained popular throughout the 19th century, during the 20th century they were somewhat eclipsed given other advances in the inter-bank financing markets. However, in 1995 the first German jumbo Covered Bond was issued, meeting investor demand for increasingly liquid products.[1] Since that time, the Covered Bond market has accelerated in Europe, partly due to the fact that Europe does not have government-sponsored enterprises such as Fannie Mae, Freddie Mac or the Federal Home Loan Banks. Furthermore, the collateral behind European Covered Bonds includes residential and commercial mortgages as well as public sector debt. At the end of 2007, the Covered Bond market stood at over EUR 2.11 trillion.[2] To date, two U.S. institutions have issued Covered Bonds.

Nearly all European countries have adopted Covered Bonds into their financial system. Depending on the jurisdiction, Covered Bonds may be governed by legislation (i.e. a "legislative framework") or by contract (i.e. a "structured framework"). Typically, a legislative framework exists in nations with a long history of Covered Bonds while nations with a relatively young Covered Bond market, such as Canada and Japan have a structured framework. In countries with a legislative framework there is often a dedicated regulator that governs the issuance and repayment of Covered Bonds. Moreover, a legislative framework helps to standardize Covered Bonds, providing homogeneity and simplicity to the market. This Best Practices document seeks to offer such structure to the U.S. market.

V. Important Considerations

The purpose of this document is to present a standardized model for Covered Bonds issued in the United States in the absence of dedicated legislation. Investors should recognize that like all investments, Covered Bonds carry risk. Investors should perform their own due diligence and review risk factors and associated disclosure before investing in any Covered Bond. These Best Practices only serve as a template for market participants and do not in any way provide or imply a government guarantee of any kind. It should also be understood that these Best Practices do not attempt to address requirements arising from federal securities laws or any other legal framework.

VI. Best Practices Template

For a Covered Bond program to be consistent with this Best Practices Template, the program's documentation must conform to the following provisions throughout the life of the program, not only at the time of issuance. *Italics indicate provisions that are specified in the final FDIC policy statement*[3].

Issuer

The issuer may be:
- *A newly created, bankruptcy-remote SPV ("SPV Structure")*[4]
- *A depository institution and/or a wholly-owned subsidiary of a depository institution ("Direct Issuance Structure")*

Security

Under the current SPV Structure, the issuer's primary assets must be a mortgage bond purchased from a depository institution. The mortgage bond must be secured at the depository institution by a dynamic pool of residential mortgages.

Under the Direct Issuance Structure, the issuing institution must designate a Cover Pool of residential mortgages as the collateral for the Covered Bond, which remains on the balance sheet of the depository institution.

In both structures, the Cover Pool must be owned by the depository institution. Issuers of Covered Bonds must provide a first priority claim on the assets in the Cover Pool to bond holders, and the assets in the Cover Pool must not be encumbered by any other lien. The issuer must clearly identify the Cover Pool's assets, liabilities, and security pledge on its books and records.

Maturity

The maturity for Covered Bonds shall be greater than one year and no more than thirty years. While the majority of early issuances will likely have maturities between one and ten years, we expect longer dated issuances may develop over time.

Eligible Cover Pool Collateral

The collateral in the Cover Pool must meet the following requirements at all times:

- *Performing mortgages on one-to-four family residential properties*
- *Mortgages shall be underwritten at the fully-indexed rate*[5]
- *Mortgages shall be underwritten with documented income*
- *Mortgages must comply with existing supervisory guidance governing the underwriting of residential mortgages, including the Interagency Guidance on Non-Traditional Mortgage Products, October 5, 2006, and the Interagency Statement on Subprime Mortgage Lending, July 10, 2007, and such additional guidance applicable at the time of loan origination*
- *Substitution collateral may include cash and Treasury and agency securities as necessary to prudently manage the Cover Pool*
- Mortgages must be current when they are added to the pool and any mortgages that become more than 60-days past due must be replaced
- Mortgages must be first lien only
- Mortgages must have a maximum loan-to-value ("LTV") of 80% at the time of inclusion in the Cover Pool
- A single Metro Statistical Area cannot make up more than 20% of the Cover Pool
- Negative amortization mortgages are not eligible for the Cover Pool
- Bondholders must have a perfected security interest in these mortgage loans.

Over-collateralization

Issuers must maintain an overcollateralization value at all times of at least 5% of the outstanding principal balance of the Covered Bonds (see "Asset Coverage Test").

For the purposes of calculating the minimum required overcollateralization in the Covered Bond, only the 80% portion of the updated LTV will be credited. If a mortgage in the Cover Pool has a LTV of 80% or less, the full outstanding principal value of the mortgage will be credited. If a mortgage has a LTV over 80%, only the 80% LTV portion of each loan will be credited (see Appendix A for examples).

Issuers must update the LTV of mortgages in the Cover Pool on a quarterly basis using a nationally-recognized, regional housing price index or other comparable measurement.

Currency Covered Bonds may be issued in any currency.

Interest Type Covered Bonds may either be fixed or floating instruments.

Interest Payment Swaps Issuers may enter into one or more swap agreements or similar contractual arrangements at the time of issuance. The purpose of such agreements include:

- To provide scheduled interest payments on a temporary basis in the event the issuer becomes insolvent
- To mitigate any timing mismatch, to the extent applicable, between interest payments and interest income

These swap agreements must be with financially sound counterparties and the identity of the counterparties must be disclosed to investors.

Currency Swap If a Covered Bond is issued in a different currency than the underlying Cover Pool (or Mortgage Bond, if applicable), the issuer shall employ a currency swap.

Specified Investment Contract Issuers must enter into a deposit agreement, e.g., guaranteed investment contract, or other arrangement whereby the proceeds of Cover Pool assets are invested (any such arrangement, a "Specified Investment") at the time of issuance with or by one or more financially sound counterparties. Following a payment default by the issuer or repudiation by the FDIC as conservator or receiver, the Specified Investment should pay ongoing scheduled interest and principal payments so long as the Specified Investment provider receives proceeds of the Cover Pool assets at least equal to the par value of the Covered Bonds.

The purpose of the Specified Investment is to prevent an acceleration of the Covered Bond due to the insolvency of the issuer.

Cover Pool Disclosure	Issuers must make available descriptive information on the Cover Pool with investors at the time an investment decision is being made and on a monthly basis after issuance. The SEC's Regulation AB provides a helpful template for preparing pool level information, such as presenting summary information in tabular or graphical format and using appropriate groups or ranges. Issuers must make this information available to investors no later than 30 days after the end of each month. As the Covered Bond market develops, issuers should consider disclosing metrics on the Cover Pools from their prior Covered Bonds whenever a new issuance occurs.
Substitution	If more than 10% of the Cover Pool is substituted within any month or if 20% of the Cover Pool is substituted within any one quarter, the issuer must provide updated Cover Pool information to investors.
Issuer Disclosure	The depository institution and the SPV (if applicable) must disclose information regarding its financial profile and other relevant information that an investor would find material.
Asset Coverage Test	The issuer must perform an Asset Coverage Test on a monthly basis to ensure collateral quality and the proper level of overcollateralization and to make any substitutions that are necessary to meet the provisions of this template. The results of this Asset Coverage Test and the results of any reviews by the Asset Monitor must be made available to investors.
Asset Monitor	The issuer must designate an independent Asset Monitor to periodically determine compliance with the Asset Coverage Test of the issuer.
Trustee	The issuer must designate an independent Trustee for the Covered Bonds. Among other responsibilities, this Trustee must represent the interest of investors and must enforce the investors' rights in the collateral in the event of an issuer's insolvency.

Treatment of Covered Bond Proceeds	In the event of a default, any losses must be allocated pro rata across Covered Bond issuances that utilize a common Cover Pool, irrespective of the maturity of the individual issuances.
SEC Registration	Covered Bonds may be issued as registered securities or may be exempt from registration under securities laws. This template is not meant to address disclosure and other requirements for a security registered with the Securities and Exchange Commission.
Regulatory Authorization	*Issuers must receive consent to issue Covered Bonds from their primary federal regulator.* Upon an issuer's request, their primary federal regulator will make a determination based on that agencies policies and procedures whether to give consent to the issuer to establish a Covered Bond program. Only well-capitalized institutions should issue Covered Bonds. As part of their ongoing supervisory efforts, primary federal regulators monitor an issuer's controls and risk management processes.
Issuance Limitations	*Covered Bonds may account for no more than four percent of an issuers' liabilities after issuance.*
Event of Breach of the Asset Coverage Test	If the Asset Coverage Test of the Covered Bond program is breached, the issuer has one month to correct such breach. If, after one month, the breach remains, the Trustee may terminate the Covered Bond program and principal and accrued interest will be returned to investors. While such a breach exists, the issuer may not issue any additional Covered Bonds.

Insolvency Procedures

As conservator or receiver for an insured depository institution (IDI), the FDIC has three options in responding to a properly structured Covered Bond transaction of the IDI:

1) continue to perform on the Covered Bond transaction under its terms;
2) pay-off the Covered Bonds in cash up to the value of the pledged collateral; or
3) allow liquidation of the pledged collateral to pay-off the Covered Bonds.

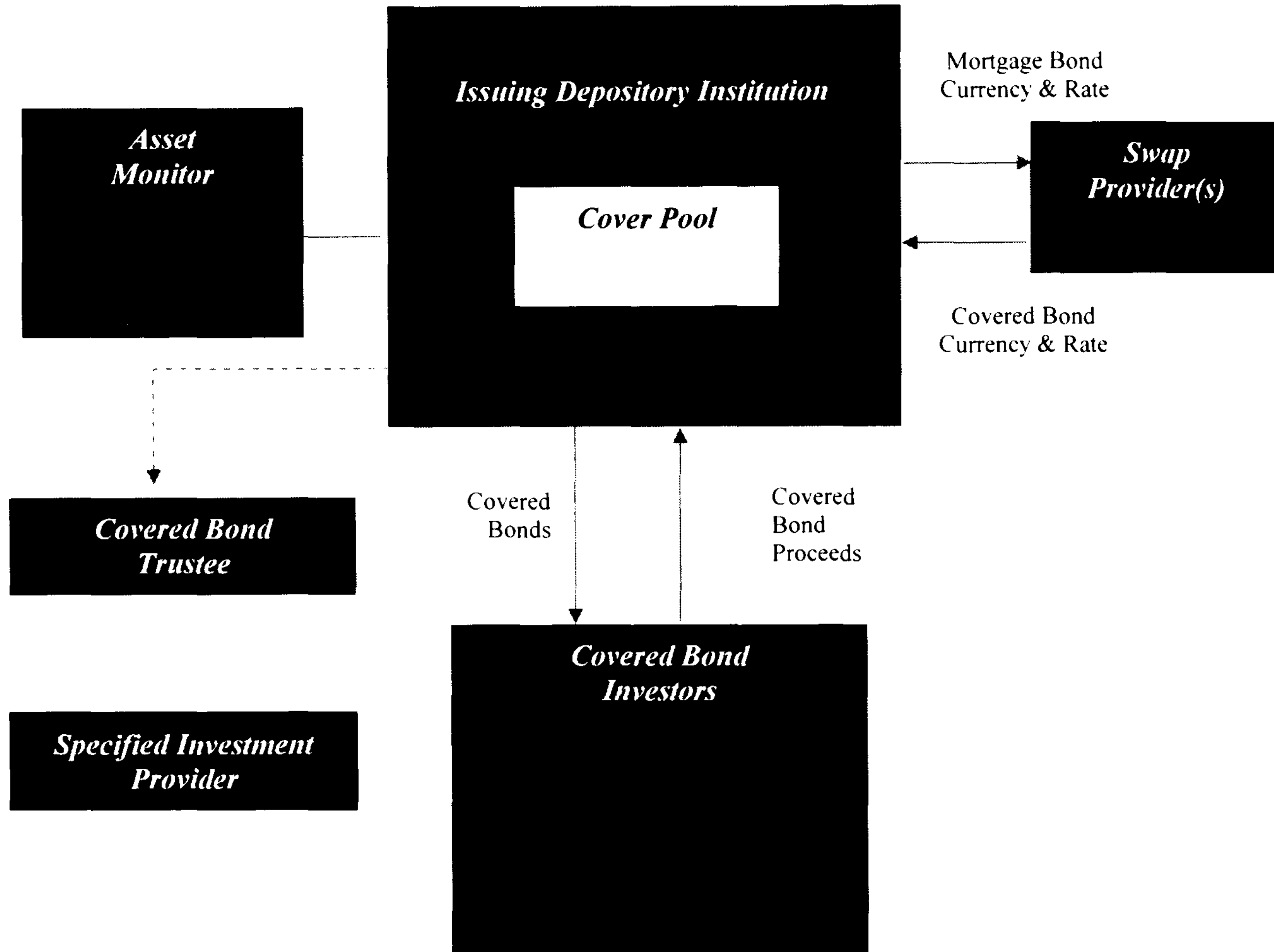
If the FDIC adopts the first option, it would continue to make the Covered Bond payments as scheduled. The second or third options would be triggered if the FDIC repudiated the transaction or if a monetary default occurred. In both cases, the par value of the Covered Bonds plus interest accrued to the date of the appointment of the FDIC as conservator or receiver would be paid in full up to the value of the collateral.

If the value of the pledged collateral exceeded the total amount of all valid claims held by the secured parties, this excess value or over collateralization would be returned to the FDIC, as conservator or receiver, for distribution as mandated by the Federal Deposit Insurance Act.

If there were insufficient collateral pledged to cover all valid claims by the secured parties, the amount of the claims in excess of the pledged collateral would be unsecured claims in the receivership.

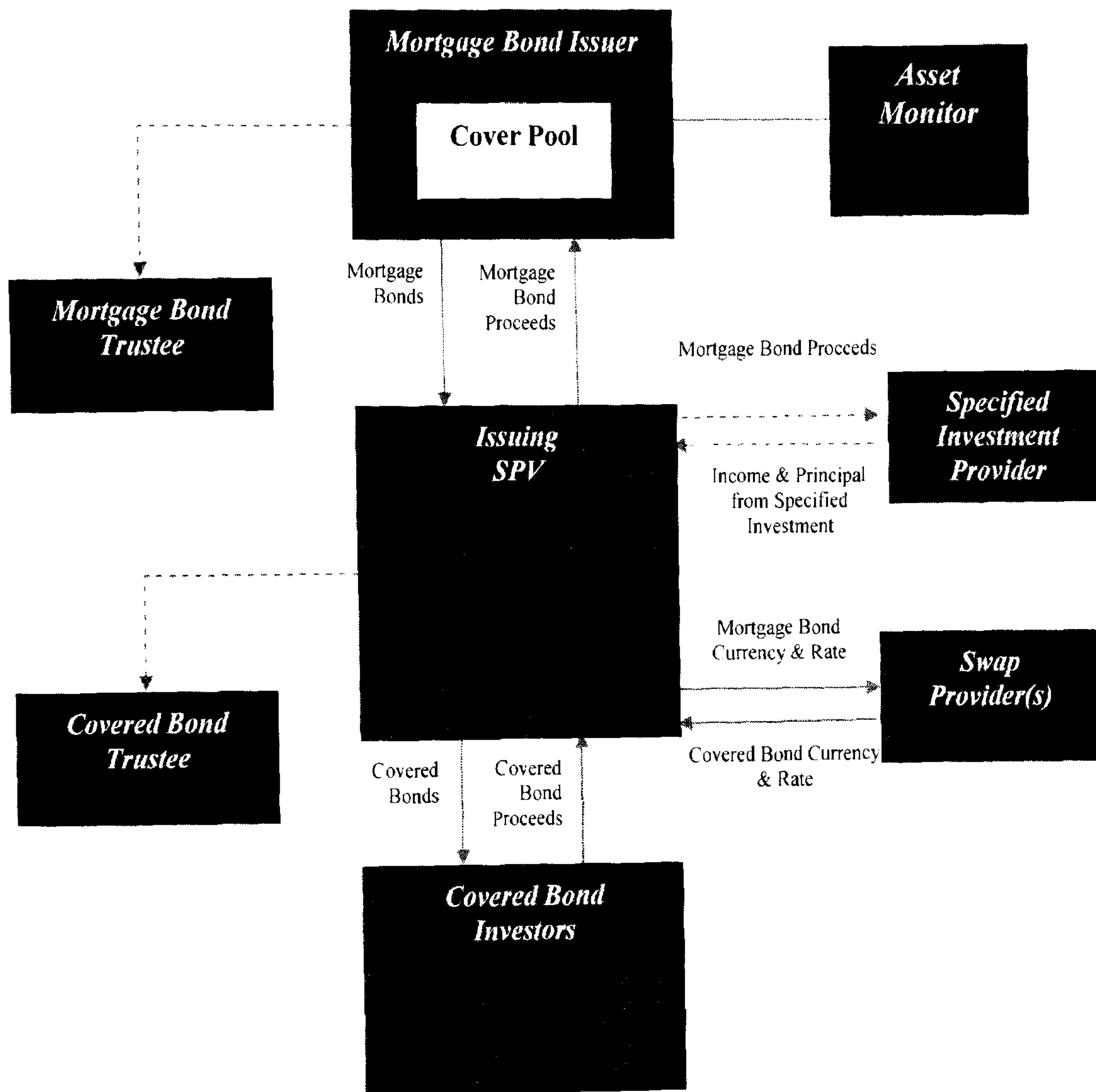
VII. Illustrative Direct Issuance

This diagram is meant to show what a potential structure could look like if the issuer of a Covered Bond were a depository institution. It is not intended to endorse a specific structure but rather serves an illustrative purpose. Issuers may develop other structures that are consistent with the template.



VIII. Illustrative SPV Issuance

This diagram is meant to show what a potential structure could look like if the issuer of a Covered Bond were a SPV. It is not intended to endorse a specific structure but rather serves an illustrative purpose. Issuers may develop other structures that are consistent with the template.



Endnotes

[1] European Covered Bond Council, December 2007.

[2] Ibid

[3] The FDIC's Final Covered Bond Policy Statement dated July 15, 2008 outlines specific actions that the FDIC will take during an insolvency or receivership if certain conditions are met. Italicized terms indicate provisions that are part of both the FDIC's statement and this Best Practices Template. However, these italicized terms are not meant to cover all of the provisions of the FDIC statement. Market participants should independently review the FDIC's statement to ensure conformity with all provisions.

[4] In addition to SPV programs with a single issuer, multiple depository institutions could potentially utilize a joint SPV to pool assets. Each issuer would be responsible for meeting appropriate requirements and receiving consent from its primary federal regulator.

[5] The fully indexed rate equals the index rate prevailing at origination plus the margin to be added to it after the expiration of an introductory interest rate. For example, assume that a loan with an initial fixed rate of 7% will reset to the six-month London Interbank Offered Rate (LIBOR) plus a margin of 6%. If the six-month LIBOR rate equals 5.5%, lenders should qualify the borrower at 11.5% (5.5% + 6%), regardless of any interest rate caps that limit how quickly the fully indexed rate may be reached.

Appendix A: Cover Pool Collateralization Calculation

As stated in Section VI., a minimum overcollateralization of 5% of the principal value of the Covered Bond must be maintained. Furthermore, mortgages must have a maximum LTV of 80% at the time of inclusion in the Cover Pool.

For the purposes of calculating the overcollateralization, 80% of the updated LTV will be credited towards the Cover Pool. For mortgages with an LTV of 80% or less, the full outstanding principal value will be credited. For mortgages with an LTV over 80%, only the 80% LTV portion of each loan will be credited.

This appendix provides examples of how loans may be credited against the required collateral of the Cover Pool.

ILLUSTRATIVE ASSUMPTIONS:

- $1,000 Covered Bond issuance
- Minimum overcollateralization of 5%
- Updated maximum LTV of 80% credited toward overcollateralization
- $1,050 of required collateral ($1,000 x 1.05)

Scenario A:

- Pool of $80 loans on homes with an updated value of $100
- $1,050 / ($80 x 1.0) = 13.125 loans required in Cover Pool

Scenario B:

- Pool of $60 loans on homes with an updated value of $100
- $1,050 / ($60 x 1.0) = 17.500 loans required in Cover Pool

Scenario C:

- Pool of $80 loans on homes with an updated value of $80
- $1,050 / ($80 x 0.8) = 16.406 loans required in Cover Pool

Appendix B: Final FDIC Covered Bond Policy Statement

FEDERAL DEPOSIT INSURANCE CORPORATION

Covered Bond Policy Statement

AGENCY: Federal Deposit Insurance Corporation (FDIC).

ACTION: Final Statement of Policy

SUMMARY: The Federal Deposit Insurance Corporation (the FDIC) is publishing a final policy statement on the treatment of covered bonds in a conservatorship or receivership. This policy statement provides guidance on the availability of expedited access to collateral pledged for certain covered bonds after the FDIC decides whether to terminate or continue the transaction. Specifically, the policy statement clarifies how the FDIC will apply the consent requirements of section 11(e)(13)(C) of the Federal Deposit Insurance Act (FDIA) to such covered bonds to facilitate the prudent development of the U.S. covered bond market consistent with the FDIC's responsibilities as conservator or receiver for insured depository institutions (IDI). As the U.S. covered bond market develops, future modifications or amendments may be considered by the FDIC.

FOR FURTHER INFORMATION CONTACT: Richard T. Aboussie, Associate General Counsel, Legal Division (703) 562-2452; Michael H. Krimminger, Special Advisor for Policy (202) 898-8950.

SUPPLEMENTARY INFORMATION

I. Background

On April 23, 2008, the FDIC published the Interim Final Covered Bond Policy Statement for public comment. 73 FR 21949 (April 23, 2008). After carefully reviewing and considering all comments, the FDIC has adopted certain limited revisions and clarifications to the Interim Policy Statement (as discussed in Part II) in the Final Policy Statement.[1]

Currently, there are no statutory or regulatory prohibitions on the issuance of covered bonds by U.S. banks. Therefore, to reduce market uncertainty and clarify the application of the FDIC's statutory authorities for U.S. covered bond transactions, the FDIC issued an Interim Policy Statement to provide guidance on the availability of expedited access to collateral pledged for certain covered bonds by IDIs in a conservatorship or a receivership. As discussed below, under section 11(e)(13)(C) of the FDIA, any liquidation of collateral of an IDI placed into

conservatorship or receivership requires the consent of the FDIC during the initial 45 days or 90 days after its appointment, respectively. Consequently, issuers of covered bonds have incurred additional costs from maintaining additional liquidity needed to insure continued payment on outstanding bonds if the FDIC as conservator or receiver fails to make payment or provide access to the pledged collateral during these periods after any decision by the FDIC to terminate the covered bond transaction. The Policy Statement does not impose any new obligations on the FDIC, as conservator or receiver, but does define the circumstances and the specific covered bond transactions for which the FDIC will grant consent to expedited access to pledged covered bond collateral.

Covered bonds are general, non-deposit obligation bonds of the issuing bank secured by a pledge of loans that remain on the bank's balance sheet. Covered bonds originated in Europe, where they are subject to extensive statutory and supervisory regulation designed to protect the interests of covered bond investors from the risks of insolvency of the issuing bank. By contrast, covered bonds are a relatively new innovation in the U.S. with only two issuers to date: Bank of America, N.A. and Washington Mutual. These initial U.S. covered bonds were issued in September 2006.

In the covered bond transactions initiated in the U.S. to date, an IDI sells mortgage bonds, secured by mortgages, to a trust or similar entity ("special purpose vehicle" or "SPV").[2] The pledged mortgages remain on the IDI's balance sheet, securing the IDI's obligation to make payments on the debt, and the SPV sells covered bonds, secured by the mortgage bonds, to investors. In the event of a default by the IDI, the mortgage bond trustee takes possession of the pledged mortgages and continues to make payments to the SPV to service the covered bonds. Proponents argue that covered bonds provide new and additional sources of liquidity and diversity to an institution's funding base.

The FDIC agrees that covered bonds may be a useful liquidity tool for IDIs as part of an overall prudent liquidity management framework and within the parameters set forth in the Policy Statement. While covered bonds, like other secured liabilities, could increase the costs to the deposit insurance fund in a receivership, these potential costs must be balanced with diversification of sources of liquidity and the benefits that accrue from additional on-balance sheet alternatives to securitization for financing mortgage lending. The Policy Statement seeks to balance these considerations by clarifying the conditions and circumstances under which the FDIC will grant automatic consent to access pledged covered bond collateral. The FDIC believes that the prudential limitations set forth in the Policy Statement permit the incremental development of the covered bond market, while allowing the FDIC, and other regulators, the opportunity to evaluate these transactions within the U.S. mortgage market. In fulfillment of its responsibilities as deposit insurer and receiver for failed IDIs, the FDIC will continue to review the development of the covered bond marketplace

in the U.S. and abroad to gain further insight into the appropriate role of covered bonds in IDI funding and the U.S. mortgage market, and their potential consequences for the deposit insurance fund. (For ease of reference, throughout this discussion, when we refer to "covered bond obligation," we are referring to the part of the covered bond transaction comprising the IDI's debt obligation, whether to the SPV, mortgage bond trustee, or other parties; and "covered bond obligee" is the entity to which the IDI is indebted.)

Under the FDIA, when the FDIC is appointed conservator or receiver of an IDI, contracting parties cannot terminate agreements with the IDI because of the insolvency itself or the appointment of the conservator or receiver. In addition, contracting parties must obtain the FDIC's consent during the forty-five day period after appointment of FDIC as conservator, or during the ninety day period after appointment of FDIC as receiver before, among other things, terminating any contract or liquidating any collateral pledged for a secured transaction.[3] During this period, the FDIC must still comply with otherwise enforceable provisions of the contract. The FDIC also may terminate or repudiate any contract of the IDI within a reasonable time after the FDIC's appointment as conservator or receiver if the conservator or receiver determines that the agreement is burdensome and that the repudiation will promote the orderly administration of the IDI's affairs.[4]

As conservator or receiver for an IDI, the FDIC has three options in responding to a properly structured covered bond transaction of the IDI: 1) continue to perform on the covered bond transaction under its terms; 2) pay-off the covered bonds in cash up to the value of the pledged collateral; or 3) allow liquidation of the pledged collateral to pay-off the covered bonds. If the FDIC adopts the first option, it would continue to make the covered bond payments as scheduled. The second or third options would be triggered if the FDIC repudiated the transaction or if a monetary default occurred. In both cases, the par value of the covered bonds plus interest accrued to the date of the appointment of the FDIC as conservator or receiver would be paid in full up to the value of the collateral. If the value of the pledged collateral exceeded the total amount of all valid claims held by the secured parties, this excess value or over collateralization would be returned to the FDIC, as conservator or receiver, for distribution as mandated by the FDIA. On the other hand, if there were insufficient collateral pledged to cover all valid claims by the secured parties, the amount of the claims in excess of the pledged collateral would be unsecured claims in the receivership.

While the FDIC can repudiate the underlying contract, and thereby terminate any continuing obligations under that contract, the FDIA prohibits the FDIC, as conservator or receiver from avoiding any legally enforceable or perfected security interest in the assets of the IDI unless the interest was taken in

contemplation of the IDI's insolvency or with the intent to hinder, delay, or defraud the IDI or its creditors.[5] This statutory provision ensures protection for

the valid claims of secured creditors up to the value of the pledged collateral. After a default or repudiation, the FDIC as conservator or receiver may either pay resulting damages in cash up to the value of the collateral or turn over the collateral to the secured party for liquidation. For example, if the conservator or receiver repudiated a covered bond transaction, as discussed in Part II below, it would pay damages limited to par value of the covered bonds and accrued interest up to the date of appointment of the conservator or receiver, if sufficient collateral was in the cover pool, or turn over the collateral for liquidation with the conservator or receiver recovering any proceeds in excess of those damages. In liquidating any collateral for a covered bond transaction, it would be essential that the secured party liquidate the collateral in a commercially reasonable and expeditious manner taking into account the then-existing market conditions.

As noted above, existing covered bond transactions by U.S. issuers have used SPVs. However, nothing in the Policy Statement requires the use of an SPV. Some questions have been posed about the treatment of a subsidiary or SPV after appointment of the FDIC as conservator or receiver. The FDIC applies well-defined standards to determine whether to treat such entities as "separate" from the IDI. If a subsidiary or SPV, in fact, has fulfilled all requirements for treatment as a "separate" entity under applicable law, the FDIC as conservator or receiver has not applied its statutory powers to the subsidiary's or SPV's contracts with third parties. While the determination of whether a subsidiary or SPV has been organized and maintained as a separate entity from the IDI must be determined based on the specific facts and circumstances, the standards for such decisions are set forth in generally applicable judicial decisions and in the FDIC's regulation governing subsidiaries of insured state banks, 12 C.F.R. § 362.4.

The requests to the FDIC for guidance have focused principally on the conditions under which the FDIC would grant consent to obtain collateral for a covered bond transaction before the expiration of the forty-five day period after appointment of a conservator or the ninety day period after appointment of a receiver. IDIs interested in issuing covered bonds have expressed concern that the requirement to seek the FDIC's consent before exercising on the collateral after a breach could interrupt payments to the covered bond obligee for as long as 90 days. IDIs can provide for additional liquidity or other hedges to accommodate this potential risk to the continuity of covered bond payments but at an additional cost to the transaction. Interested parties requested that the FDIC provide clarification about how FDIC would apply the consent requirement with respect to covered bonds. Accordingly, the FDIC has determined to issue this Final Covered Bond Policy Statement in order to provide covered bond issuers with final guidance on how the FDIC will treat covered bonds in a conservatorship or receivership.

II. Overview of the Comments

The FDIC received approximately 130 comment letters on the Interim Policy Statement; these included comments from national banks, Federal Home Loan Banks, industry groups and individuals.

Most commenters encouraged the FDIC to adopt the Policy Statement to clarify how the FDIC would treat covered bonds in the case of a conservatorship or receivership and, thereby, facilitate the development of the U.S. covered bond market. The more detailed comments focused on one or more of the following categories of issues: (1) the FDIC's discretion regarding covered bonds that do not comply with the Policy Statement; (2) application to covered bonds completed prior to the Policy Statement; (3) the limitation of the Policy Statement to covered bonds not exceeding 4 percent of liabilities; (4) the eligible collateral for the cover pools; (5) the measure of damages provided in the event of default or repudiation; (6) the covered bond term limit; and (7) federal home loan bank advances and assessments.

Certain banks and industry associations sought clarification about the treatment of covered bonds that do not comply with the Policy Statement by the FDIC as conservator or receiver. Specifically, commenters asked the FDIC to clarify that if a covered bond issuance is not in conformance with the Policy Statement, the FDIC retains discretion to grant consent prior to expiration of the 45 or 90 day period on a case-by-case basis. Under Section 11(e)(13)(C) of the FDIA, the exercise of any right or power to terminate, accelerate, declare a default, or otherwise affect any contract of the IDI, or to take possession of any property of the IDI, requires the consent of the conservator or receiver, as appropriate, during the 45-day period or 90-day period after the date of the appointment of the conservator or receiver, as applicable. By the statutory terms, the conservator or receiver retains the discretion to give consent on a case-by-case basis after evaluation by the FDIC upon the failure of the issuer.

Comments from banks who issued covered bonds prior to the Policy Statement requested either 'grandfathering' of preexisting covered bonds or an advance determination by the FDIC before any appointment of a conservator or receiver that specific preexisting covered bonds qualified under the Policy Statement. After carefully considering the comments, the FDIC has determined that to 'grandfather' or otherwise permit mortgages or other collateral that does not meet the specific requirements of the Policy Statement to support covered bonds would not promote stable and resilient covered bonds as encompassed within the Policy Statement. If preexisting covered bonds, and their collateral, otherwise qualify under the standards specified in the Policy Statement, those covered bonds would be eligible for the expedited access to collateral provided by the Policy Statement.

A number of commenters requested that the limitation of eligible covered bonds to no more than 4 percent of an IDI's total liabilities should be removed or increased. Commenters also noted that other countries applying a cap have based the limitation on assets, not liabilities. The Policy Statement applies to covered bond issuances that comprise no more than 4 percent of an institution's total liabilities since, in part, as the proportion of secured liabilities increases the unpledged assets available to satisfy the claims of the Deposit Insurance Fund, uninsured depositors and other creditors decreases. As a result, the FDIC must focus on the share of an IDI's liabilities that are secured by collateral and balance the additional potential losses in the failure of an IDI against the benefits of increased liquidity for open institutions. The 4 percent limitation under the Policy Statement is designed to permit the FDIC, and other regulators, an opportunity to evaluate the development of the covered bond market within the financial system of the United States, which differs in many respects from that in other countries deploying covered bonds. Consequently, while changes may be considered to this limitation as the covered bond market develops, the FDIC has decided not to make any change at this time.

A number of commenters sought expansion of the mortgages defined as "eligible mortgages" and the expansion of collateral for cover pools to include other assets, such as second-lien home equity loans and home equity lines of credit, credit card receivables, mortgages on commercial properties, public sector debt, and student loans. Other commenters requested that "eligible mortgages" should be defined solely by their loan-to-value (LTV) ratios. After considering these comments, the FDIC has determined that its interests in efficient resolution of IDIs, as well as in the initial development of a resilient covered bond market that can provide reliable liquidity for well-underwritten mortgages, support retention of the limitations on collateral for qualifying covered bonds in the Interim Policy Statement. Recent market experience demonstrates that many mortgages that would not qualify under the Policy Statement, such as low documentation mortgages, have declined sharply in value as credit conditions have deteriorated. Some of the other assets proposed are subject to substantial volatility as well, while others would not specifically support additional liquidity for well-underwritten residential mortgages. As noted above, certain provisions of the Policy Statement may be reviewed and reconsidered as the U.S. covered bond market develops.

With regard to the comments that LTV be used as a guide to determine an "eligible mortgage," the FDIC does not believe that LTV can substitute for strong underwriting criteria to ensure sustainable mortgages. In response to the comments, and the important role that LTV plays in mortgage analysis, the Policy Statement will urge issuers to disclose LTV for mortgages in the cover pool to enhance transparency for the covered bond market and promote stable cover pools. However, no specific LTV limitation will be imposed.

Two commenters suggested that the Policy Statement should be clarified to permit the substitution of cash as cover pool collateral. The Policy Statement has been modified to allow for the substitution of cash and Treasury and agency securities. The substitution of such collateral does not impair the strength of the cover pool and may be an important tool to limit short-term strains on issuing IDIs if eligible mortgages or AAA-rated mortgage securities must be withdrawn from the cover pool.

A number of commenters requested guidance on the calculation of damages the receiver will pay to holders of covered bonds in the case of repudiation or default. Under 12 USC § 1821(e)(3), the liability of the conservator or receiver for the disaffirmance or repudiation of any contract is limited to "actual direct compensatory damages" and determined as of the date of appointment of the conservator or receiver. In the repudiation of contracts, such damages generally are defined by the amount due under the contract repudiated, but excluding any amounts for lost profits or opportunities, other indirect or contingent claims, pain and suffering, and exemplary or punitive damages. Under the Policy Statement, the FDIC agrees that "actual direct compensatory damages" due to bondholders, or their representative(s), for repudiation of covered bonds will be limited to the par value of the bonds plus accrued interest as of the date of appointment of the FDIC as conservator or receiver. The FDIC anticipates that IDIs issuing covered bonds, like other obligations bearing interest rate or other risks, will undertake prudent hedging strategies for such risks as part of their risk management program.

Many commenters suggested that the 10-year term limit should be removed to permit longer-term covered bond maturities. After reviewing the comments, the FDIC agrees that longer-term covered bonds should not pose a significant, additional risk and may avoid short-term funding volatility. Therefore, the FDIC has revised the Interim Policy Statement by increasing the term limit for covered bonds from 10 years to 30 years.

A number of the Federal Home Loan Banks, and their member institutions, objected to the inclusion of FHLB advances in the definition of "secured liabilities," any imposed cap on such advances, and any change in assessment rates. Under 12 C.F.R. Part 360.2 (Federal Home Loan Banks as Secured Creditors), secured liabilities include loans from the Federal Reserve Bank discount window, Federal Home Loan Bank (FHLB) advances, repurchase agreements, and public deposits. However, the Policy Statement does not impose a cap on FHLB advances and has no effect on an IDI's ability to obtain FHLB advances or its deposit insurance assessments. The Policy Statement solely addresses covered bonds.

However, as noted above, where an IDI relies very heavily on secured liabilities to finance its lending and other business activities, it does pose a greater risk of loss to the Deposit Insurance Fund in any failure. Should the covered bond market develop as a significant source of funding for IDIs, and should that development create substantial increases in an IDI's reliance on secured funding, it would increase the FDIC's losses in a failure and perhaps outweigh the benefits of improved liquidity. As a result, it is appropriate for the FDIC to consider the risks of such increased losses. Consideration of these risks may occur in a possible future request for comments on secured liabilities, but they are not addressed in this Policy Statement.

III. Final Statement of Policy

For the purposes of this final Policy Statement , a "covered bond" is defined as a non-deposit, recourse debt obligation of an IDI with a term greater than one year and no more than thirty years, that is secured directly or indirectly by a pool of eligible mortgages or, not exceeding ten percent of the collateral, by AAA-rated mortgage bonds. The term "covered bond obligee" is the entity to which the IDI is indebted.

To provide guidance to potential covered bond issuers and investors, while allowing the FDIC to evaluate the potential benefits and risks that covered bond transactions may pose to the deposit insurance fund in the U.S. mortgage market, the application of the policy statement is limited to covered bonds that meet the following standards.

This Policy Statement only applies to covered bond issuances made with the consent of the IDI's primary federal regulator in which the IDI's total covered bond obligations at such issuance comprise no more than 4 percent of an IDI's total liabilities. The FDIC is concerned that unrestricted growth while the FDIC is evaluating the potential benefits and risks of covered bonds could excessively increase the proportion of secured liabilities to unsecured liabilities. The larger the balance of secured liabilities on the balance sheet, the smaller the value of assets that are available to satisfy depositors and general creditors, and consequently the greater the potential loss to the Deposit Insurance Fund. To address these concerns, the policy statement is limited to covered bonds that comprise no more than 4 percent of a financial institution's total liabilities after issuance.

In order to limit the risks to the deposit insurance fund, application of the Policy Statement is restricted to covered bond issuances secured by perfected security interests under applicable state and federal law on performing eligible mortgages on one-to-four family residential properties, underwritten at the fully indexed rate and relying on documented income, a limited volume of AAA-rated mortgage securities, and certain substitution collateral. The Policy Statement provides that the mortgages shall be underwritten at the fully indexed rate relying on

documented income, and comply with existing supervisory guidance governing the underwriting of residential mortgages, including the Interagency Guidance on Non-Traditional Mortgage Products, October 5, 2006, and the Interagency

Statement on Subprime Mortgage Lending, July 10, 2007, and such additional guidance applicable at the time of loan origination. In addition, the Policy Statement requires that the eligible mortgages and other collateral pledged for the covered bonds be held and owned by the IDI. This requirement is designed to protect the FDIC's interests in any over collateralization and avoid structures involving the transfer of the collateral to a subsidiary or SPV at initiation or prior to any IDI default under the covered bond transaction.

The FDIC recognizes that some covered bond programs include mortgage-backed securities in limited quantities. Staff believes that allowing some limited inclusion of AAA-rated mortgage-backed securities as collateral for covered bonds during this interim, evaluation period will support enhanced liquidity for mortgage finance without increasing the risks to the deposit insurance fund. Therefore, covered bonds that include up to 10 percent of their collateral in AAA-rated mortgage securities backed solely by mortgage loans that are made in compliance with guidance referenced above will meet the standards set forth in the Policy Statement. In addition, substitution collateral for the covered bonds may include cash and Treasury and agency securities as necessary to prudently manage the cover pool. Securities backed by tranches in other securities or assets (such as Collateralized Debt Obligations) are not considered to be acceptable collateral.

The Policy Statement provides that the consent of the FDIC, as conservator or receiver, is provided to covered bond obligees to exercise their contractual rights over collateral for covered bond transactions conforming to the Interim Policy Statement no sooner than ten (10) business days after a monetary default on an IDI's obligation to the covered bond obligee, as defined below, or ten (10) business days after the effective date of repudiation as provided in written notice by the conservator or receiver.

The FDIC anticipates that future developments in the marketplace may present interim final covered bond structures and structural elements that are not encompassed within this Policy Statement and therefore the FDIC may consider future amendment (with appropriate notice) of this Policy Statement as the U.S. covered bond market develops.

IV. Scope and Applicability:

This Policy Statement applies to the FDIC in its capacity as conservator or receiver of an insured depository institution.

This Policy Statement only addresses the rights of the FDIC under 12 U.S.C. § 1821(e)(13)(C). A previous policy statement entitled "Statement of Policy on Foreclosure Consent and Redemption Rights," August 17, 1992, separately addresses consent under 12 U.S.C. § 1825(b), and should be separately consulted.

This Policy Statement does not authorize, and shall not be construed as authorizing, the waiver of the prohibitions in 12 U.S.C. § 1825(b)(2) against levy, attachment, garnishment, foreclosure or sale of property of the FDIC, nor does it authorize or shall it be construed as authorizing the attachment of any involuntary lien upon the property of the FDIC. The Policy Statement provides that it shall not be construed as waiving, limiting or otherwise affecting the rights or powers of the FDIC to take any action or to exercise any power not specifically mentioned, including but not limited to any rights, powers or remedies of the FDIC regarding transfers taken in contemplation of the institution's insolvency or with the intent to hinder, delay or defraud the institution or the creditors of such institution, or that is a fraudulent transfer under applicable law.

The Board of Directors of the FDIC has adopted a final Covered Bond Policy Statement. The text of the Covered Bond Policy Statement follows:

COVERED BOND POLICY STATEMENT

Background

Insured depository institutions ("IDIs") are showing increasing interest in issuing covered bonds. Although covered bond structures vary, in all covered bonds the IDI issues a debt obligation secured by a pledge of assets, typically mortgages. The debt obligation is either a covered bond sold directly to investors, or mortgage bonds which are sold to a trust or similar entity ("special purpose vehicle" or "SPV") as collateral for the SPV to sell covered bonds to investors. In either case, the IDI's debt obligation is secured by a perfected first priority security interest in pledged mortgages, which remain on the IDI's balance sheet. Proponents argue that covered bonds provide new and additional sources of liquidity and diversity to an institution's funding base. Based upon the information available to date, the FDIC agrees that covered bonds may be a useful liquidity tool for IDIs as part of an overall prudent liquidity management framework and the parameters set forth in this policy statement. Because of the increasing interest IDIs have in issuing covered bonds, the FDIC has determined to issue this policy statement with respect to covered bonds.

(a) Definitions.

(1) For the purposes of this policy statement, a "covered bond" shall be defined as a non-deposit, recourse debt obligation of an IDI with a term greater than one year and no more than thirty years, that is secured directly or indirectly by perfected

security interests under applicable state and federal law on assets held and owned by the IDI consisting of eligible mortgages, or AAA-rated mortgage-backed securities secured by eligible mortgages if for no more than ten percent of the collateral for any covered bond issuance or series. Such covered bonds may permit substitution of cash and United States Treasury and agency securities for the initial collateral as necessary to prudently manage the cover pool.

(2) The term "eligible mortgages" shall mean performing first-lien mortgages on one-to-four family residential properties, underwritten at the fully indexed rate[6] and relying on documented income, and complying with existing supervisory guidance governing the underwriting of residential mortgages, including the Interagency Guidance on Non-Traditional Mortgage Products, October 5, 2006, and the Interagency Statement on Subprime Mortgage Lending, July 10, 2007, and such additional guidance applicable at the time of loan origination. Due to the predictive quality of loan-to-value ratios in evaluating residential mortgages, issuers should disclose loan-to-value ratios for the cover pool to enhance transparency for the covered bond market.

(3) The term "covered bond obligation," shall be defined as the portion of the covered bond transaction that is the insured depository institution's debt obligation, whether to the SPV, mortgage bond trustee, or other parties.

(4) The term "covered bond obligee" is the entity to which the insured depository institution is indebted.

(5) The term "monetary default" shall mean the failure to pay when due (taking into account any period for cure of such failure or for forbearance provided under the instrument or in law) sums of money that are owed, without dispute, to the covered bond obligee under the terms of any bona fide instrument creating the obligation to pay.

(6) The term "total liabilities" shall mean, for banks that file quarterly Reports of Condition and Income (Call Reports), line 21 "Total liabilities" (Schedule RC); and for thrifts that file quarterly Thrift Financial Reports (TFRs), line SC70 "Total liabilities" (Schedule SC).

(b) Coverage. This policy statement only applies to covered bond issuances made with the consent of the IDI's primary federal regulator in which the IDI's total covered bond obligation as a result of such issuance comprises no more than 4 percent of an IDI's total liabilities, and only so long as the assets securing the covered bond obligation are eligible mortgages or AAA-rated mortgage securities on eligible mortgages, if not exceeding 10 percent of the collateral for any covered bond issuance. Substitution for the initial cover pool collateral may include cash and Treasury and agency securities as necessary to prudently manage the cover pool.

(c) Consent to certain actions. The FDIC as conservator or receiver consents to a covered bond obligee's exercise of the rights and powers listed in 12 U.S.C. § 1821(e)(13)(C), and will not assert any rights to which it may be entitled pursuant to 12 U.S.C. § 1821(e)(13)(C), after the expiration of the specified amount of time, and the occurrence of the following events:

(1) If at any time after appointment the conservator or receiver is in a monetary default to a covered bond obligee, as defined above, and remains in monetary default for ten (10) business days after actual delivery of a written request to the FDIC pursuant to paragraph (d) hereof to exercise contractual rights because of such monetary default, the FDIC hereby consents pursuant to 12 U.S.C. § 1821(e)(13)(C) to the covered bond obligee's exercise of any such contractual rights, including liquidation of properly pledged collateral by commercially reasonable and expeditious methods taking into account existing market conditions, provided no involvement of the receiver or conservator is required.

(2) If the FDIC as conservator or receiver of an insured depository institution provides a written notice of repudiation of a contract to a covered bond obligee, and the FDIC does not pay the damages due pursuant to 12 U.S.C. § 1821(e) by reason of such repudiation within ten (10) business days after the effective date of the notice, the FDIC hereby consents pursuant to 12 U.S.C. § 1821(e)(13)(C) for the covered bond obligee's exercise of any of its contractual rights, including liquidation of properly pledged collateral by commercially reasonable and expeditious methods taking into account existing market conditions, provided no involvement of the receiver or conservator is required.

(3) The liability of a conservator or receiver for the disaffirmance or repudiation of any covered bond issuance obligation, or for any monetary default on, any covered bond issuance, shall be limited to the par value of the bonds issued, plus contract interest accrued thereon to the date of appointment of the conservator or receiver.

(d) Consent. Any party requesting the FDIC's consent as conservator or receiver pursuant to 12 U.S.C. § 1821(e)(13)(C) pursuant to this policy statement should provide to the Deputy Director, Division of Resolutions and Receiverships, Federal Deposit Insurance Corporation, 550 17th Street, NW, F-7076, Washington DC 20429-0002, a statement of the basis upon which such request is made, and copies of all documentation supporting such request, including without limitation a copy of the applicable contract and of any applicable notices under the contract.

(e) Limitations. The consents set forth in this policy statement do not act to waive or relinquish any rights granted to the FDIC in any capacity, pursuant to any other applicable law or any agreement or contract. Nothing contained in this policy

alters the claims priority of collateralized obligations. Nothing contained in this policy statement shall be construed as permitting the avoidance of any legally enforceable or perfected security interest in any of the assets of an insured depository institution, provided such interest is not taken in contemplation of the institution's insolvency, or with the intent to hinder, delay or defraud the IDI or its creditors. Subject to the provisions of 12 U.S.C. § 1821(e)(13)(C), nothing contained in this policy statement shall be construed as permitting the conservator

or receiver to fail to comply with otherwise enforceable provisions of a contract or preventing a covered bond obligee's exercise of any of its contractual rights, including liquidation of properly pledged collateral by commercially reasonable methods.

(f) No waiver. This policy statement does not authorize, and shall not be construed as authorizing the waiver of the prohibitions in 12 U.S.C. § 1825(b)(2) against levy, attachment, garnishment, foreclosure, or sale of property of the FDIC, nor does it authorize nor shall it be construed as authorizing the attachment of any involuntary lien upon the property of the FDIC. Nor shall this policy statement be construed as waiving, limiting or otherwise affecting the rights or powers of the FDIC to take any action or to exercise any power not specifically mentioned, including but not limited to any rights, powers or remedies of the FDIC regarding transfers taken in contemplation of the institution's insolvency or with the intent to hinder, delay or defraud the institution or the creditors of such institution, or that is a fraudulent transfer under applicable law.

(g) No assignment. The right to consent under 12 U.S.C. § 1821(e)(13)(C) may not be assigned or transferred to any purchaser of property from the FDIC, other than to a conservator or bridge bank.

(h) Repeal. This policy statement may be repealed by the FDIC upon 30 days notice provided in the Federal Register, but any repeal shall not apply to any covered bond issuance made in accordance with this policy statement before such repeal.

By order of the Board of Directors
Dated at Washington, DC this ______ day of ______, 2008.
Federal Deposit Insurance Corporation

Robert E. Feldman
Executive Secretary

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1 For ease of reference, the Interim Final Covered Bond Policy Statement, published on April 23, 2008, will be referred to as the Interim Policy Statement. The Final Covered Bond Policy Statement will be referred to as the Policy Statement.

2 The FDIC understands that certain potential issuers may propose a different structure that does not involve the use of an SPV. The FDIC expresses no opinion about the appropriateness of SPV or so-called "direct issuance" covered bond structures, although both may comply with this Statement of Policy.

3 See 12 U.S.C. § 1821(e)(13)(C).

4 See 12 U.S.C. §§ 1821(e)(3) and (13). These provisions do not apply in the manner stated to "qualified financial contracts" as defined in Section 11(e) of the FDI Act. See 12 U.S.C. § 1821(e)(8).

5 See 12 U.S.C. §1821(e) (12).

6 The fully indexed rate equals the index rate prevailing at origination plus the margin to be added to it after the expiration of an introductory interest rate. For example, assume that a loan with an initial fixed rate of 7% will reset to the six-month London Interbank Offered Rate (LIBOR) plus a margin of 6%. If the six-month LIBOR rate equals 5.5%, lenders should qualify the borrower at 11.5% (5.5% + 6%), regardless of any interest rate caps that limit how quickly the fully indexed rate may be reached.

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OFFICE OF DOMESTIC FINANCE

Key Initiatives

BEST PRACTICES FOR RESIDENTIAL COVERED BONDS

The Administration is focused on pursuing a range of initiatives to help homeowne preventable foreclosures and to speed the recovery from the housing correction. C bonds have the potential to help homebuyers and those seeking to refinance by in mortgage financing. Covered bonds can also help strengthen U.S. financial institut providing a new funding source that will diversify their overall funding portfolio. The Department has developed Best Practices for Residential Covered Bonds to serve starting-point for the covered bond market by encouraging issuers to use a commc with high quality collateral.

BEST PRACTICES

Best Practices for Residential Covered Bonds

Fact Sheet

NEWS AND ANNOUNCEMENTS

Date	Title
07/28/2008	Treasury Releases Best Practices to Encourage Additional Form of M Finance

SPEECHES

Date	Title
07/28/2008	Secretary Henry M. Paulson, Jr. Statement on Covered Bond Best Pr
07/08/2008	Paulson Remarks on U.S. Housing Market Before FDIC's Forum on M Lending
03/13/2008	Paulson Remarks on Recommendations from the PWG

RESOURCES

FDIC Final Covered Bond Policy Statement

Remarks by Chairman Shelia Bair, FDIC

Remarks by Governor Kevin Warsh, Federal Reserve

Remarks by Comptroller John Dugan, OCC

Policy Statement of the PWG

Last Updated

July 28, 2008
HP-1103

**Assistant Secretary for Economic Policy Phillip Swagel
Treasury Borrowing Advisory Committee of the
Securities Industry and Financial markets Association Statement**

Washington - The U.S. economy has continued to expand at a moderate pace despite the effects of the housing correction, financial market strains, and high energy prices. These developments have weighed on economic growth and the labor market since late 2007.

Real GDP growth was 1.0 percent at an annual rate in the first quarter of this year, after 0.6 percent growth at an annual rate in the fourth quarter of 2007. Net exports sustained growth, while consumer spending and business investment grew slowly, and housing investment fell sharply. A narrower trade deficit accounted for much of the first-quarter increase in GDP, contributing 0.8 percentage point to real growth. Real exports rose at a 5½ percent annual rate in the first quarter, while real imports declined slightly. Consumer spending growth moderated to a 1.1 percent annual rate and the growth of business investment slowed to just 0.6 percent. Residential investment plunged by nearly 25 percent at an annual rate in the first quarter, subtracting more than 1 percentage point from annualized real GDP growth for a third straight quarter.

Later this week, on Thursday, July 31, the Bureau of Economic Analysis (BEA) will release the advance estimate of GDP growth in the second quarter. BEA will also release revised data for 2005- 2007 GDP growth that incorporate more complete source data and methodological changes.

Available data suggest that growth picked up in the second quarter of 2008; the consensus of forecasts is for 2.3 percent growth at an annual rate. Consumer spending has been solid, boosted by nearly $80 billion in stimulus payments received by households. Data on capital goods shipments and on non-residential construction suggest that business investment in plant and equipment expanded at a moderate pace. Export growth remained robust through May, and trade appears poised to make another positive contribution to real GDP growth. Strength in these sectors will be offset by declines in residential investment and business inventory investment.

The housing correction has been a drag on GDP growth since 2006 and residential investment will likely subtract from GDP through the end of 2008. Overbuilding left home inventories far above normal levels; the key to stabilizing the housing market is to work through the inventories. Inventories of unsold new single-family homes have declined by 26 percent since their peak in July 2006, but remain near historically high levels. A decline in construction is a necessary part of the housing correction after years of overbuilding--and housing starts and building permits are down sharply. Single-family starts have fallen by 65 percent from their peak in January 2006 and in June slipped to a 17-1/2 year low.

A stabilization of home sales at a high enough level to outpace construction is the key to working through the inventories of new homes. New single-family home sales have been roughly flat for the past 3 months after having fallen by about 60 percent from their peak in July 2005. Existing home sales also show signs of stabilizing since the beginning of this year. These are fragile signs, however: new home sales stabilized for several months in the spring of 2007 before falling again.

Elevated inventories of unsold homes continue to weigh on house prices, which fell 4.8 percent over the year ending in May, according to figures from the Office of Federal Housing Enterprise Oversight (OFHEO). Other measures of home prices, including the S&P/Case-Shiller indices, indicate that home prices continue to decline in many major U.S. cities. Mortgage delinquencies and foreclosures are up

sharply--the number of mortgages past due and the number of foreclosures started have both risen over 150 percent since early 2006. Rising foreclosures are a source of difficulty for many families. They also prolong the adjustment process for housing, since foreclosures add to the supply of homes on the market and because homes sold out of foreclosure put additional downward pressure on home prices. Subprime adjustable-rate mortgages are largely responsible for the elevated delinquency and foreclosure rates, but foreclosure starts on prime loans are rising as well, suggesting that credit difficulties have spread.

Weakness in housing, credit market strains, and high energy prices have taken a toll on the labor market, which has stalled since late last year. Nonfarm payrolls fell by an average of 73,000 per month in the first six months of 2008. These were the first job losses in 5 years and together nearly offset the 453,000 jobs gained in the last half of 2007. The unemployment rate stood at 5.5 percent in June, up nearly a full percentage point over the past year.

Overall inflation recently hit a 17-year high, with the consumer price index up 5 percent in the 12 months ending in June; this compares to an increase of 2.6 percent in the year-earlier period. Surging energy prices and sharp increases in food costs are responsible for the pickup in consumer inflation. Excluding these categories, core consumer price inflation remained contained at 2.4 percent in the latest twelve month period through June. This was a pace of core inflation just 0.2 percentage point higher than in the year ended June 2007.

Consumer energy prices rose further in July, although at a slower pace than in April through June. Retail gasoline prices increased about 1 percent in the first three weeks of July to an average of $4.09 per gallon but have since fallen off somewhat. Gasoline prices had risen by an average of 7.6 percent in each of the prior 4 months, with the cost of regular gas up by more than 30 percent so far this year. Higher gasoline prices largely reflect oil market developments: between late 2007 and mid July of this year, the benchmark one-month futures price of West Texas Intermediate crude oil rose by more than 50 percent, closing at an all-time high of $145 per barrel on July 14. Oil prices have eased substantially since then, falling by nearly $25 to $123 per barrel as of last Friday (July 25). Though oil is still 70 percent more costly than a year ago, the recent drop in price is good news for consumers and businesses alike.

Elevated overall inflation has more than offset nominal wage increases so that real average hourly earnings are down by 1.8 percent for the year ending in June. The stimulus measures enacted early this year have countered some of the impacts of high energy prices and the slow job market, boosting real household income and thereby helping to sustain household spending. A total of 112.4 million stimulus payments were sent to households through July 11, totaling $92 billion. Around 12 million additional rebate payments are expected to go out through the remainder of 2008 and the first half of 2009 as additional people file returns or reconcile their 2008 incomes during the 2009 tax season. This includes stimulus payments that will go to the over 5 million seniors and veterans who must still file a simple tax return to receive their payment.

The economic slowdown and increased expenditures associated with slower growth and with the stimulus has had an effect on the federal budget. Today the Office of Management and Budget released the Mid-Session Review of the FY2009 Budget, which contains updated estimates of federal receipts, outlays, and the deficit for the next five years. For FY2008, the deficit is projected to be $389 billion, or about 2.7 percent of GDP. In FY2009, the deficit is projected to rise to $482 billion, about 3.3 percent of GDP. The rising deficits in FY2008 and FY2009 largely reflect the slowing economy and the stimulus package. Federal receipts are projected at 17.9 percent of GDP in FY2008 and FY2009, about 0.4 percentage point below the long-run average. As the temporary stimulus provisions end and the economy strengthens, receipts are projected to rise. Spending discipline and rising receipts would bring the federal budget to surplus in FY2012 and FY2013.

The Mid-Session Review is based on an updated economic forecast in which GDP growth in 2008 is projected to be 1.6 percent on a year-over-year basis, more than a percentage point lower than the forecast in the FY2009 Budget. The Mid-Session Review GDP forecast matches the private consensus projection for growth in 2008. The updated forecast projects relatively sluggish growth in 2009 (2.2 percent), which is 0.8 percentage point below the growth projected in the Budget. The economy is predicted to recover as the housing market stabilizes and financial

turmoil recedes, with annual GDP growth picking up to average about 3.2 percent through 2013. This pace of growth would bring the unemployment rate down to 4.8 percent in 2012 after it increases in 2008 and 2009 as a result of sluggish growth.

Prompt and effective policy actions are supporting growth while adjustments in housing and financial markets continue. The fundamental strengths of the U.S. economy remain, notably strong underlying productivity growth and substantial flexibility and resilience. Over time, stronger growth will bring renewed job creation and higher incomes, and this in turn will result in rising federal receipts and move the fiscal position toward a balanced budget.

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July 28, 2008
HP-1104

Treasury Announces Marketable Borrowing Estimates

Washington- Treasury announced its current estimates of marketable borrowing today for the July – September 2008 and October – December 2008 quarters:

- Over the July – September 2008 quarter, the Treasury expects to borrow $171 billion of marketable debt, assuming an end-of-September cash balance of $45 billion. This borrowing estimate is $59 billion higher than announced in April 2008. The increase in borrowing is primarily due to higher outlays and lower net issuances of State and Local Government Series securities.
- Over the October – December 2008 quarter, the Treasury expects to borrow $142 billion of marketable debt, assuming an end-of-December cash balance of $40 billion.

During the April – June 2008 quarter, Treasury borrowed $13 billion of marketable debt, finishing with a cash balance of $53 billion at the end of June. In April 2008, Treasury estimated a pay down in marketable borrowing of $35 billion, assuming an end-of-June cash balance of $45 billion. The increase in borrowing was primarily the result of lower receipts, higher outlays, redemptions of portfolio holdings by the Federal Reserve System and adjustments to cash balances.

Treasury estimates total marketable borrowing of $555 billion in FY 2008. Note that beginning in April 2008, in order to more accurately reflect borrowing from private market participants, redemptions from the Federal Reserve's System Open Market Account (SOMA) were excluded from Treasury's marketable borrowing estimates. To date this fiscal year, the Federal Reserve System redeemed $151 billion in SOMA holdings. The table below details the impact of excluding SOMA redemptions in the actual results for the three previous quarters.

Additional financing details relating to Treasury's Quarterly Refunding will be released at 9:00 a.m. on Wednesday, July 30.

REPORTS

- Sources and Uses Table
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Sources and Uses Reconciliation Table						
		Financing				
		Financing Need	Marketable Borrowing	All Other Sources	Total	Change in Cash Balance
Quarter	*Announcement Date*	(1)	(2)	(3)	(4) = (2) + (3)	(5) = (4) - (1)
Oct - Dec 2005	**Actual**	**97**	**93**	**6**	**98**	**1**
Jan - Mar 2006	**Actual**	**173**	**159**	**(15)**	**144**	**(28)**
Apr - Jun 2006	**Actual**	**(137)**	**(91)**	**(8)**	**(99)**	**38**
Jul - Sep 2006	**Actual**	**19**	**49**	**(23)**	**26**	**6**
Oct - Dec 2006	**Actual**	**70**	**46**	**2**	**48**	**(21)**
Jan - Mar 2007	**Actual**	**159**	**126**	**9**	**134**	**(25)**
Apr - Jun 2007	**Actual**	**(153)**	**(139)**	**5**	**(133)**	**19**
Jul - Sep 2007	**Actual**	**35**	**116**	**(31)**	**85**	**50**
Oct - Dec 2007	**Actual**	**91**	**126**	**(53)**	**73**	**(18)**
Jan - Mar 2008	**Actual**	**187**	**244**	**(68)**	**176**	**(11)**
Apr - Jun 2008	**April 28, 2008**	**(83)**	**(35)**	**(49)**	**(84)**	**(1)**
	July 28, 2008	**(74)**	**13**	**(80)**	**(66)**	**7**
	Memo: Forecast Revision	9	48	(30)	18	8

Jul - Sep 2008	**April 28, 2008**	**103**	**112**	**(10)**	**103**	**0**
	July 28, 2008	**159**	**171**	**(20)**	**151**	**(8)**
	Memo: Forecast Revision	56	59	(11)	48	(8)
Oct - Dec 2008	**April 28, 2008**	**117**	**119**	**(7)**	**112**	**(5)**
	July 28, 2008	**135**	**142**	**(11)**	**130**	**(5)**
	Memo: Forecast Revision	18	22	(5)	18	(0)

	Oct-Dec 2007	Jan-Mar 2008	Apr-Jun 2008	Jul-Sep 2008	FY 2008	Oct-Dec 2008
Marketable Borrowing (Including SOMA)	87	191	-45	171	404	142
SOMA Redemptions	-39	-53	-58	-	-151	0
Marketable Borrowing (Excluding SOMA)	126	244	13	171	555	142

July 29, 2008
HP-1105

Treasury Designates Burmese State-Owned Enterprises

Washington, DC--The U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) today announced financial sanctions against ten companies owned or controlled by the Government of Burma or its officials, including companies involved in the gem-mining industry. The action coincides with the President's signing of the Tom Lantos Block Burmese JADE (Junta's Anti-Democratic Efforts) Act of 2008, legislation aimed at extending sanctions against leaders of the Burmese military regime, those providing such leaders with economic and political support, their immediate family members, and the Burmese gem industry, an important source of revenue for the Burmese military regime.

"We are tightening financial sanctions against Burma's repressive junta and the companies that finance it," said OFAC Director Adam J. Szubin. "The regime's refusal to protect and allow relief to reach the Burmese people as Cyclone Nargis devastated their country is but another example of the regime's heartless neglect of its people."

Today's action by Treasury targets two conglomerates, the Union of Myanmar Economic Holdings Limited (UMEH) and the Myanmar Economic Corporation, both of which have extensive interests in a variety of sectors critical to the Government of Burma, including the gem, banking, and construction industries. Four of UMEH's subsidiary companies--Myanmar Ruby Enterprise, Myanmar Imperial Jade Company Ltd., Myawaddy Trading Ltd., and Myawaddy Bank Ltd.--have been added to OFAC's Specially Designated Nationals and Blocked Persons list as a result of today's action.

Today's action also targets the "No. 1 Mining Enterprise," "No. 2 Mining Enterprise," and "No. 3 Mining Enterprise," all of which are owned by the Burmese Ministry of Mines. The Cooperative Import Export Enterprise, a trading company under the Burmese Ministry of Cooperatives, has been sanctioned today as well.

This action was taken pursuant to Executive Order 13464, which authorizes the Secretary of the Treasury to block the property and interests in property of, among others, entities owned or controlled by, directly or indirectly, the Government of Burma or an official or officials of the Government of Burma. On April 30, 2008, President Bush blocked the property and interests in property of three Burmese state-owned enterprises, Myanmar Gem Enterprise, Myanmar Timber Enterprise, and Myanmar Pearl Enterprise, named in the Annex to Executive Order 13464.

Today's designation freezes all assets of the designated persons subject to U.S. jurisdiction and prohibits all financial and commercial transactions by any U.S. person with the designated persons. The designations also make available to the global community information about companies that provide vital support to the Burmese military and to a regime that is systematically oppressing the Burmese people.

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PRESS ROOM
U.S. DEPARTMENT OF THE TREASURY

July 29, 2008
HP-1106

Under Secretary for International Affairs David H. McCormick
Remarks at the Peterson Institute for International Economics

"Oil Markets: Principles, Perceptions, and Prices"

Washington - These are challenging times for the U.S. economy. The economy is slowing in the wake of a significant downturn in the housing sector, tenuous financial markets, and unprecedented commodity prices. Chief among the concerns on the minds of most American consumers is the dramatic rise in the price of oil. High oil prices are an enormous burden on American families and the U.S. economy, as well as families and economies around the world. Further, the growing financial imbalances created by the flow of oil and money between consumers and producers are both concerning and unsustainable.

In January 2002, a barrel of oil cost about $20. By January 2005, the price had more than doubled, and by January of this year, the price had doubled again. Earlier this month, the price approached $150 per barrel. More recently, as concerns about the slowdown of the global economy increased and as fears of hurricane-related disruptions of oil production in the Gulf of Mexico dissipated, the price of oil dropped to its current level of about $125 per barrel.

Today I'd like to discuss why this dramatic increase in price has happened and what we should do about it. Simply put, the world economy – and with it global demand for oil – has been growing rapidly, and the supply of oil has not kept pace. In response, prices must rise to allocate limited supply. These long term trends are indisputable, and they are the primary drivers of the increase in oil prices.

Our challenge is complicated, however, by the fact that the difficulties we face in achieving a secure, stable, and cost-effective worldwide supply of energy are the flip side of the pressing need to address global climate change. There are no simple solutions to these deeply interconnected problems. But there are steps that policymakers can pursue now to put us on a path to a more stable supply of lower cost energy while also reducing the emissions of greenhouse gases. While my remarks today focus on high oil prices, the actions we take on this front -- and in achieving energy security more broadly -- can and must be consistent with our efforts to protect the planet.

A Fundamentals Story

On the demand side of the fundamentals story, we start with a positive development. Global economic growth from 2002 through the end of last year was remarkably strong, averaging about 4.25 percent in real terms, led by emerging market economies, like China and India. This has not only benefited millions of people within these countries, but also strengthened industrial economies through access to dynamic, high-potential export markets.

Most of the world's largest energy consumers are industrialized economies. But the growth in emerging markets has been accompanied by an increasing thirst for electricity and automobiles and the consequent extraordinary growth in demand for oil. According to the U.S. Energy Information Administration (EIA), global oil consumption jumped about 9 million barrels per day since 2001, with the lion's share of this increase concentrated in economies where per capita consumption of oil is relatively low.

On the other side of the equation, global oil supply has not kept pace with the remarkable growth in the global economy and oil demand. Between 2002 and the present, the quantity of oil produced has risen at an average annual rate of about 2 percent, less than half the rate of expansion of the global economy. The economics

are clear: With strong growth in demand and sluggish increases in production, the price must go up to allocate the limited oil available. This is what we have seen over the past several years.

Why has oil supply growth been slow? First, real investment in new capacity to produce oil has been weak around the world. Oil prices troughed after the Asian crisis in 1997, at one point going below $10 per barrel, as hard as that is to believe right now. At that price, there was minimal investment, capacity and workforces were cut, and spending on exploration fell sharply. In addition, the wave of nationalization of oil production and the increasing concentration of oil resources in global hot spots has resulted in reduced investment.

Most oil fields take years to develop, and in some cases a decade or longer. Because investment has been curtailed over the last decade, we now barely have the oil needed to offset declining production in older fields, let alone increase production to meet new demand. And looking ahead, it is increasingly the case that oil reserves are located where it is geologically difficult to develop them, and even greater investment will be needed to tap these resources.

Second, oil fields go through a natural progression. They start up, peak, and slow down. Over the past few years, a number of major fields are producing significantly less, and that loss has to be made up simply to keep global production flat.

This rising demand and stagnant supply has steadily chipped away at global spare capacity. In the 1990s, spare capacity averaged over 4 million barrels per day. Over the last five years, however, spare capacity has averaged less than half that amount and has dropped even more dramatically as a share of global consumption. Into this mix, we throw the third key factor that has affected the supply of oil – disruptions, or the perception of growing potential for disruption, resulting from events such as wars, civil turmoil, or hurricanes in the Gulf of Mexico. With little spare capacity to buffer against these events, these disruptions, and the fear of possible future disruptions, feed directly into higher prices.

Turning to this year, expectations of supply and demand have changed significantly, and account for most of the rapid run up in price over the past six months. This development is explained by the fact that perceptions about future supply and demand can and do affect prices today.

For example, suppose it becomes clear that there will be a significant decline in the supply of oil six months from now. In that case, if you were a large consumer of oil, what would you do? You would likely buy as much oil as you could now, to avoid paying the future higher price. Yet, by buying the extra oil now, you would motivate the very price increase you anticipated. This also works in reverse. Expected future increases in supply, or future declines in demand, or some combination of the two, decrease the current price.

Over the past year, the market has gradually factored in the realization that supply is not keeping pace with demand. There was no one event that led to this realization. But a collection of small events -- production delays for new oil fields, shortages in oil drilling equipment, surprising resilience of emerging markets as the global economy has slowed, and growing geopolitical uncertainty in the Persian Gulf -- changed market perceptions about current and future oil supply and demand.

We also see that even small changes in fundamentals can have large effects on prices, particularly in tight markets with a limited buffer between supply and demand. Again, back to basic economics: If supply falls by one percent, consumption must decline by an equal amount. That decline is brought about by an increase in price. Unfortunately, it is difficult to get people to reduce oil consumption, because it is so fundamental to everything we do and there are no close substitutes for it at present. Therefore, the price has to rise sharply to induce the necessary changes in consumption. We see this inelastic demand in current prices and feel its effects in our day-to-day lives.

So far, and despite their prominence in the news, I have not mentioned either speculation or currency depreciation. The reason is simple. The effects of these two factors are relatively minor in comparison to changes in the fundamentals that have been building up for a decade or longer. I am not dismissing them completely, but I

want to put them in proper perspective. We must not let concerns over these second-order factors distract us from focusing our attention on the root cause of dramatic increases in price – a growing gap between the world's desire to consume oil and its capacity to produce it.

Other Contributing Factors

In oil futures markets, there are three types of participants: hedgers – these are market participants with commercial interests in oil, like oil companies or airlines, that need futures markets to offset the business risk created by volatile prices. Pension and index funds – these are typically funds that seek to diversify their assets with investments in commodities and who buy and hold for the long term. And, short-term investors often referred to as speculators – these are market participants with no commercial interest in oil who bet on future changes in the price.

Investors, whether focused on the long-term or short-term, play a crucial role by supporting a large and liquid oil market that makes it easier and cheaper for hedgers to minimize their business risks. Of course, there are well-documented examples of how small groups of investors have cornered markets in the past by hoarding physical commodities. This behavior is better known as "manipulation," and is rightly illegal. The Commodities Futures Trading Commission (CFTC) routinely polices markets and prosecutes such manipulation, and currently there is no evidence of hoarding. According to the EIA, inventories in the United States, and industrial countries more generally, are falling. Moreover, the CFTC's market monitoring shows that net positions of short-term investors have not grown relative to the overall market over the past two years, precisely the time at which they are being accused of causing the price of oil to soar.

Short-term investors can move prices – sometimes in a good way, like when they quickly move the market to incorporate the latest information, and sometimes in a bad way, like when they get caught having to "buy back" large bets on price swings that don't materialize. Clearly, they can contribute in this way to the volatility in prices that we have seen in recent months. However, by creating a large and liquid market, they also help reduce volatility, and over the longer haul, short-term investors do not systematically move prices away from the levels dictated by the fundamentals of supply and demand.

Some also assert that investors pouring money into oil futures contracts are driving up the price. Once again, however, there is little evidence to suggest that investment flows into futures are causing the rise in the price if oil. For example, the prices of other commodities, for which there are no futures markets and in which these funds are not investing, have risen as much or more than oil. As with oil, global demand for these commodities has increased dramatically, while supply has not kept pace. Fundamentals, not investment flows, are driving increases in these commodity prices and in oil.

Similarly, the effect of the depreciation of the dollar on oil prices is relatively small. The price of oil has soared regardless of the currency in which its price is quoted. For example, since early 2002, the euro-price of oil has shot up 250 percent, and the yen-price jumped 400 percent. Further, in the past 120 days, the dollar price of oil has risen more than 20 percent, while the real value of the dollar has changed very little.

It is true that a decline in the value of the dollar could result in higher demand for oil in countries whose currencies appreciate against the dollar. Everything else being equal, the price of oil in their local currency is cheaper and therefore could stimulate demand. However, over the last two years, consumption of oil in Europe has been flat, despite a strong appreciation of the euro against the dollar, suggesting that there are other factors more important than currency movements.

The Path Ahead

In many ways, I wish the problems we face were as straightforward as speculation or currency depreciation. Unfortunately, in addressing long-term trends in the supply and demand for oil there are no easy solutions. We must take significant, credible, and comprehensive action today to change the dynamics of energy supply and demand in the longer term. Such steps will not only help over time to resolve

the gap between supply and demand, but will also result in lower prices in the present.

First, we must better understand this rapidly changing market. Efforts to study the dynamics of the oil market are already underway. The International Energy Agency and the IMF have been charged by the G-8 Finance Ministers to dig deeply into the root causes of this problem. Similarly, the interim CFTC report released last week and the final study to be released in September are an important contribution to this debate. There are also much needed efforts underway to improve the available data on financial flows in oil futures markets, oil inventories, and proven reserves. Better data and more transparency will greatly reduce the uncertainty that contributes to higher prices.

Second, in terms of supply, we must cultivate an open investment climate at home and abroad through bilateral investment treaties, free trade agreements, and pro-investment policies. Greater investment in oil production and refining capacity, as well as in alternative sources of energy, is urgently required. Production in key countries such as Mexico, Russia, and Venezuela is declining, the vast majority of the world's oil reserves are nationally-owned, and one third of reserves are in countries that allow no foreign investment. Policies that restrict market access deny these markets much needed capital, know-how, cutting-edge technology, and entrepreneurism.

We also need to invest more within our own borders, and we need to do so in an environmentally sustainable way. A few weeks ago, the President lifted the executive ban on exploration of the Outer Continental Shelf, and he has called for America to do its part to increase the global supply of oil by increasing domestic exploration, leasing oil shale on federal lands, and streamlining the refinery permitting process. These measures have the potential to increase domestic supply in the long run and to bring far greater credibility to our efforts to encourage increased production overseas.

We must also pursue energy diversification by increasing investment in alternative sources of energy in the United States and around the world. In this regard, the government can play an important role by supporting basic research on critical technologies and creating market incentives for the private sector to develop and rapidly deploy alternative energy sources. Under President Bush's leadership, the United States has made real progress in these areas. Since 2001, we have spent more than $12 billion to research, develop, and promote alternative energy sources. Similarly, as a result of the President's renewable fuels mandate, use of these types of fuels is projected to exceed 8 percent of the U.S. gasoline supply by 2015, more than double the 4 percent that it is today.

Of course, with the price of oil at roughly $125 per barrel, the private sector has every incentive to invest in alternative energy, and here we see market forces already at work. For example, electric cars are actually being produced by several start-up companies, and established U.S. automobile manufacturers plan to introduce their own electric vehicles as early as 2010. Given the magnitude of the challenge, we and other nations must accelerate our efforts to develop and deploy these and other game-changing technologies, such as modern, safe nuclear facilities, wind power, and carbon capture and sequestration that are on the cusp of widespread commercialization.

Third, we must take steps to stem global oil demand. To this end, President Bush has implemented the first significant increase in car fuel economy standards in more than two decades. We can also work to better educate consumers on how they can conserve as they make energy conservation a social and financial priority. For example, in response to high fuel prices, a recent Gallup poll indicated that more than 80 percent of Americans are taking steps to cut back on their daily driving, and we already see the effect in a four percent decline in U.S. gasoline consumption this year.

Also on the demand side, we should ensure that critical price signals are not obscured by subsidies. Currently over 50 percent of the world's population has access to subsidized fuels (and 22 percent of all gasoline purchases are subsidized). We don't expect countries to remove all subsidies tomorrow, and we welcome the steps that some countries, like China and India, have already taken. But the countries that subsidize need to develop a plan to eliminate subsidies over time. Just formulating and beginning to implement a credible plan could impact

current oil prices. Not only will such efforts result in greater market transparency that will allow price signals to lower global demand for oil, but they will remove a significant economic burden on governments that subsidize, allowing them to dedicate these resources to more productive purposes.

The list of potential policy options is long, and I have only highlighted a few of the many that should be pursued. Ultimately, a complete package of actions must be taken by energy producers and consumers alike to reduce oil consumption, increase the diversity of energy supply, and put prices on a lower and more stable trajectory.

Conclusion

We face a great challenge, but we are no strangers to adversity. Addressing it will require new investment, new innovation, and significant changes in how we consume and conserve energy, but in a way that maintains the vibrancy of America's economy.

Because the dramatic rise in the cost of oil is a global dilemma, it is one that we must tackle in concert with others. Affordable, environmentally-sound, and economically sustainable energy supply is in the interest of the entire global community -- producers and consumers, developed countries, and those developing. Success will require us to take tangible, credible, and significant steps to address the fundamentals of supply and demand, and, to do so in a way that substantially reduces global carbon emissions in the coming decades.

To overcome this enormous challenge, Americans must do what we have always done – adapt, innovate, persevere, and prevail. I am confident we are up to the task.

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July 31, 2008
HP-1107

**Remarks by Secretary Henry M. Paulson, Jr.
on the Markets and Economy
at the Exchequer Club**

Washington - Good afternoon. Thank you for the opportunity to share my thoughts on the current state of the U.S. economy, and our housing and capital markets.

U.S. Economy

Data released this morning show that our economy expanded in the second quarter – GDP growth was 1.9 percent. This despite an unusually large inventory reduction which subtracted 1.9 percentage points from growth. Consumption added 1.1 percentage points – with a good boost from the stimulus. Trade continues to drive growth, adding 2.4 percentage points. Earlier this year, before the bipartisan stimulus plan was enacted, many had predicted far slower growth, even approaching zero. Clearly, the stimulus plan has supported the U.S. economy during this difficult period, and couldn't have been timelier. American families spent; companies invested and benefited from strong export growth.

I spent time last fall and winter traveling the country, and heard from many homeowners about their mortgage and other housing difficulties, and of their concerns about the broader economy. I also talked to people in a variety of industries and asked them what their business was telling them about where the economy was headed. My travels, my discussions with industry leaders and a review of the economic data with the rest of the President's economic team convinced me in mid-December that the economy had taken a sharp turn for the worse and the risks were to the downside going forward. President Bush recognized the downturn early, and directed me to work with Congress to craft legislation to bolster both consumer spending and business investment to protect the health of our economy. We all worked together quickly to enact a stimulus package that is temporary, targeted, big enough to have an impact and easy to implement quickly.

On April 28, just 75 days after the President signed the Economic Stimulus Act of 2008, the first electronic deposits were sent into Americans' bank accounts. One week later, the first week of May, paper checks were being printed and mailed. In the second quarter, Treasury employees sent almost 95 million payments totaling over $78 billion to American households. The Financial Management Service managed the high demands of tax season and simultaneously printed stimulus checks; the IRS has handled millions of taxpayer inquiries over the phones and through its website. Given the enormity of the effort, it was accomplished effectively and with minimal disruptions.

The private sector offered promotions that increased stimulus payment buying power. Local and national retailers, from vacation planners to supermarkets, gave incentives, sometimes as much as a 10 percent bonus, to those who spent their checks at those businesses.

We also know that companies are taking advantage of the stimulus package's temporary tax incentives. Businesses ranging from restaurants to computer service providers are using these provisions to invest in their companies and grow. We expect the stimulus to continue to support the economy in the second half of the year.

While the stimulus is making our economy stronger than it would have been otherwise, the housing correction, credit market turmoil, and high energy prices remain a considerable drag on the economy – and the effects of this drag can be seen in the soft job market.

Record high oil prices, which have increased dramatically since year-end, are putting a large burden on the U.S. and the world economy and creating hardships for families, households and industries everywhere. There are no simple or quick remedies for this. High oil prices are the result of supply and demand factors that are likely to persist for some time.

On the positive side, global economic growth from 2002 through the end of 2007 was remarkably strong, averaging over 4 percent. This growth, led by emerging market economies like China and India, has lifted millions of people around the world out of poverty. As living standards improve in emerging economies, demand for oil will continue to rise. Producers, unfortunately, have not made the investments necessary to keep pace with this growing demand. Because production capacity and investment has been curtailed over the last decade, supply now barely offsets declining production in older fields, let alone meets new demand.

Successfully alleviating the pressures in oil markets will require a long-term, comprehensive effort to keep supply on pace with demand. On the demand side, we need to allow market forces to work, to avoid subsidies and other potentially distorting policies. We also need to reduce oil dependency through investments in renewable fuels and alternative technologies, and improved energy efficiency and conservation.

While our economy faces substantial difficulties that will continue to be a drag on growth in the short term, it is important to remember that our long term fundamentals are strong. Recognizing the challenges ahead of us, I expect our economy to continue growing this year although at a moderate pace. We are making progress although not in a straight line; housing continues to be at the heart of our economic challenges and remains our most significant downside risk. We must work through the necessary adjustments in housing and credit markets to return to stronger growth next year and beyond.

Housing Markets

It took years of excesses – lax underwriting standards, excessive home price appreciation and overbuilding – to sow the seeds of the housing correction.

That said, we need to recognize that there is not a national housing market, but a collection of regional markets. The severity of the current correction varies widely by state and region. Areas that had some of the most pronounced price appreciation are facing the most pronounced price declines and foreclosure increases. Of course, that does not mean the correction isn't being felt across the nation. Foreclosure starts as a share of total outstanding mortgages have risen from 0.4 percent to 1.0 percent since the beginning of 2006. However, OFHEO's home price data shows that home prices actually rose in about half of the states in the first quarter.

Due to overbuilding in prior years, home inventories are now far above normal levels. At the current sales rate, there is a ten month inventory of new single-family homes on the market, and an 11 month inventory of existing single-family homes. This compares with a historical average of about six to seven months. The key to stabilizing the housing and financial markets is to work through these home inventories as quickly as possible.

Inventories decrease in two ways – fewer homes are built, and more buyers come into the market. We are seeing the necessary sharp decline in homebuilding. Single-family housing starts are down 65 percent from their 2006 peak and look to remain weak through this year.

New home sales appear to have stabilized to a degree – sales of new single-family homes are down 62 percent from their peak; and sales have been flat, rather than declining, for three months now. The drastic slowing in new construction has helped reduce the number of new single-family homes on the market, which is down 26 percent since its 2006 peak. The number of existing homes on the market remains elevated, but there are also tentative signs that sales in this category have been stabilizing since early 2008.

We all recognize that foreclosure sales increase inventories and, as foreclosed homes are put on the market, they drive down prices. Foreclosures and short sales

now make up about one-third of existing home sales.

Treasury has worked closely with lenders and key industry participants on an aggressive strategy to do everything possible to help avoid preventable foreclosures. Last summer, we foresaw a wave of struggling homeowners and recognized that without some changes, the industry's protocol would not be able to handle the volume of homeowners seeking assistance. We supported the creation of the HOPE NOW Alliance of industry participants to work to avoid a market failure, in which homeowners who otherwise would have been able to modify or refinance into an affordable mortgage instead lost their homes simply because the system was too overwhelmed to help them. HOPE NOW has been instrumental in this effort and the industry reports that it has helped 1.9 million homeowners avoid foreclosure through loan workouts since last July. At the current pace, nearly 200,000 additional borrowers are helped every month.

From the outset of the HOPE NOW process, I have measured success by whether a borrower who has made all the payments at the initial rate, but couldn't afford the reset and reached out for help avoids going into foreclosure. And so far, the data on this question show an unqualified success. However, given the lax underwriting standards that preceded this correction, some people bought homes that they simply cannot afford. Many of them will become renters again.

Foreclosures and existing home inventories are likely to remain substantially elevated this year and next and home prices are likely to decline further on a national basis. The key question is, "When will the correction be largely behind us?" While home price adjustments will continue for some time, and certainly well beyond the end of the year, I believe we can move through the bulk of the correction in months rather than years.

Supporting the Availability of Mortgage Finance

Of course, to turn the corner mortgage financing must be available. We need more homebuyers to return to the market and buy homes, and to do that they need available and affordable mortgage financing. We have taken several steps to support the mortgage financing market now, and to address some of the structural issues that contributed to the current credit contraction.

In the past year, the FHA has implemented several initiatives to expand access to mortgage credit to troubled borrowers and since last August, nearly 300,000 borrowers have refinanced into affordable FHA fixed rate mortgages. Yesterday, President Bush signed the Housing and Economic Recovery Act into law, which will modernize FHA programs to provide greater access to FHA mortgages, including to some borrowers who are underwater on their mortgage.

More importantly to our system, the new law also includes significant, temporary provisions that will boost market confidence in the two current, largest sources of U.S. mortgage finance, the housing GSEs Fannie Mae and Freddie Mac, and establish the world-class regulator needed to address the systemic risk they pose.

Fannie and Freddie's continued activity is central to the speed with which we emerge from this housing correction and remove the underlying financial market and financial institution uncertainty. The temporary liquidity and capital backstops included in this new law are aimed at supporting the short and longer term stability of financial markets, not just these two enterprises. I would rather not have been in the position of asking for extraordinary authorities to support the GSEs. But I am playing the hand that I have been dealt. We saw a clear need to strengthen Fannie and Freddie's ability to continue to play their important role in financing mortgages and in our capital markets more broadly. There are no plans to access either of these temporary backstops. If accessing them becomes necessary, we would do so only under terms and conditions that protect the U.S. taxpayer.

Over the longer term, it is just as vital to our housing markets and our capital markets that structural concerns about the GSEs be addressed. We have long maintained that the GSEs have the potential to pose a systemic risk and recent events remove any debate on that question. Congress now has created a GSE regulator with authorities appropriate to the task and on par with other financial regulators. We have long sought this result, and our work is far from done. All parties must get to work immediately to begin to address the systemic risk issues

posed by the GSEs.

In addition to securitization done by Fannie and Freddie, private mortgage-backed securitization provides additional mortgage funding for U.S. homebuyers. This private-label securitization has become severely strained. The sooner we work through the housing correction stabilizing home prices will do much to alleviate uncertainty about the values of mortgage-related assets. The private-label market will evolve in response to current challenges, and I expect it to return with greater risk-awareness and investor discipline.

As we focus on reinvigorating the traditional sources of mortgage financing, we have studied the range of other available choices. Three days ago, Treasury and U.S. regulators were joined by the nation's four largest banks to announce a Best Practices guide to kick-start the residential covered bonds market. Covered bonds are used for mortgage financing throughout the United Kingdom and Europe, and I believe covered bonds are a promising path for a new source of mortgage financing that will complement our existing system.

Capital Markets

The housing correction has fostered capital market strains that are having an impact on the broader economy. Tighter credit standards and increased interest rate spreads affect anyone who wants to buy a house or a car, get a credit card, or take out a loan to pay for school. Credit market strains affect cities, institutions and companies looking to fund long-term projects. Along with the Federal Reserve, we have taken aggressive actions to provide confidence and stability to financial markets, and I continue to urge financial institutions to strengthen their balance sheets by raising capital, de-leveraging and reviewing dividend policies so that they continue to play their vital role in supporting economic growth.

Even in this difficult environment, financial institutions have raised $190 billion in capital. Markets and financial institutions continue to reassess risk and re-price securities across a number of asset classes and sectors. This is a positive return to market fundamentals, and we are making progress. However, until the housing market stabilizes further we should expect some continued stresses in our financial markets.

Our first and most urgent priority is working through the housing downturn and capital market turmoil, and that will be our priority until these situations are resolved. At the same time, we are also examining and addressing the policy issues raised by the events of recent months. Our regulators are shining a light on our challenges, and market practices and discipline on the part of financial institutions and investors are improving. Through the President's Working Group on Financial Markets, the PWG, we have issued a report analyzing the causes of the current turmoil and recommending a comprehensive policy response, implementation of which is well underway. Regulators are enhancing guidance, issuing new rules, and communicating more effectively across agencies – domestically and internationally.

In addition to these immediate actions, the Bear Stearns episode and market turmoil more generally have placed in stark relief the outdated nature of our financial regulatory system, and reinforced my view that it must be updated.

In March, after almost a year of study and analysis, we released our recommendations in the Blueprint for a Modernized Financial Regulatory Structure. It is as compelling now as ever that we need a financial regulatory structure better suited to protect investors, protect the stability of the financial system, support the innovation and risk-taking that fuel our economy and improve both market oversight and market discipline.

In our Blueprint, we recommend a U.S. regulatory model based on objectives that more closely link the regulatory structure to the reasons why we regulate. Our model proposes three primary regulators that are organized by objective rather than functional financial institution category: one regulator focused on market stability across the entire financial sector, another focused on safety and soundness of institutions supported by a federal guarantee, and a third focused on protecting consumers and investors. This structure takes into account the new financial landscape and the role played by non-bank institutions and can more easily adapt to the ever-changing marketplace. Our Blueprint also recognizes the critical role

market discipline plays in maintaining stability.

When we released the Blueprint, I was clear that it was a long-term vision that would take time to consider and implement. That is still the case, but today we have both a clear need and a unique opportunity to accelerate this process.

Whether it was Long Term Capital Management in 1998 or Bear Stearns this year, Americans have come to expect the Federal Reserve to step in to avert events that pose unacceptable systemic risk. But, as we noted in our Blueprint, the Fed has neither the clear statutory authority nor the mandate to attempt to anticipate and prevent risks across our entire financial system. Therefore we should consider how most appropriately to give the Federal Reserve the information and authority necessary to play its expected role of market stability regulator. The Fed would need the authority to access necessary information from complex financial institutions -- whether it is a commercial bank, an investment bank, a hedge fund, or another type of financial institution -- and the tools to intervene to mitigate systemic risk in advance of a crisis.

This is a tall order. History teaches us that in a dynamic market economy regulation alone cannot eliminate instability. To be clear, I do not believe that we can eliminate, by regulation or otherwise, all future bouts of market instability -- they are difficult to predict and past history may be a poor predictor of the future. However, just because the overall task is difficult, we should not stop trying to understand and mitigate instability.

To that end, we should create a system that gives us the best chance of foreseeing a crisis, including a market stability regulator with the authorities to avert systemic issues it foresees and providing the information, tools and authorities to deal better with unexpected events when they inevitably occur.

To complement this regulator's efforts, we must have strong market discipline to reinforce the stability of our markets. Market discipline constrains risk most effectively when a financial institution can fail without threatening the overall system.

However, two concerns underpin expectations of regulatory intervention to prevent a failure. They are that an institution may be too interconnected to fail or too big to fail. We must take steps to reduce the perception that this is so -- and that requires that we reduce the likelihood that it is so.

Strengthening market infrastructure will reduce the expectation that an institution is too interconnected to fail. We need to strengthen our practices and financial infrastructure in the OTC derivatives market and in the tri-party repo system. Important work is underway in each of these areas, and needs to be completed quickly.

To address the perception that some institutions are too big to fail, we must improve the tools at our disposal for facilitating the orderly failure of a large complex financial institution. Today, our tools are limited. We have specialized resolution provisions that apply solely to insured depository institutions. For these institutions, this special insolvency regime was deemed necessary because of the role these institutions play in the overall financing of economic activity and the presence of a government guarantee.

In contrast, bankruptcy law serves as the resolution regime for non-depository financial institutions and most corporations. These two very different approaches for resolution have advantages and disadvantages. Bankruptcy imposes market discipline on creditors, but in a time of crisis could involve undue market disruption.

We need to consider broadly the resolution regime in light of a changed financial landscape where non-bank financial institutions play a significantly greater role. It is clear that some institutions, if they fail, can have a systemic impact, so we must give regulators the authorities to limit that impact and facilitate an orderly failure. In my view, looking beyond the immediate market challenges of today, we need to create a resolution process that ensures the financial system can withstand the failure of a large complex financial firm. To do this, we will need to give our regulators additional emergency authority to limit temporary disruptions. These authorities should be flexible and -- to reinforce market discipline -- the trigger for

invoking such authority should be very high, such as a bankruptcy filing. As part of this process we should consider ways to ensure that costs are imposed on creditors and equity holders. Any commitment of government support should be an extraordinary event that requires the engagement of the Executive Branch. It should be focused on areas with the greatest potential for market instability and should contain sufficient criteria to ensure that the cost to the taxpayers is minimized.

Conclusion

This period of market stress has revealed broader financial regulatory issues, and we are working to address these on a number of fronts as I have described. We remain focused and vigilant. I am confident that we will work through current challenges and Americans will benefit from an economy that emerges stronger and better poised for robust growth.

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PRESS ROOM

July 31, 2008
2008-7-31-16-39-1-6046

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $75,704 million as of the end of that week, compared to $75,855 million as of the end of the prior week.

I. Official reserve assets and other foreign currency assets (approximate market value, in US millions)

	July 18, 2008		
A. Official reserve assets (in US millions unless otherwise specified) [1]	Euro	Yen	Total
(1) Foreign currency reserves (in convertible foreign currencies)			75,704
(a) Securities	10,159	12,014	22,174
of which: issuer headquartered in reporting country but located abroad			0
(b) total currency and deposits with:			
(i) other national central banks, BIS and IMF	14,572	5,910	20,482
ii) banks headquartered in the reporting country			0
of which: located abroad			0
(iii) banks headquartered outside the reporting country			0
of which: located in the reporting country			0
(2) IMF reserve position [2]	5,154		
(3) SDRs [2]	9,855		
(4) gold (including gold deposits and, if appropriate, gold swapped) [3]	11,041		
--volume in millions of fine troy ounces	261.499		
(5) other reserve assets (specify)	6,998		
--financial derivatives			
--loans to nonbank nonresidents			
--other (foreign currency assets invested through reverse repurchase agreements)	6,998		
B. Other foreign currency assets (specify)			
--securities not included in official reserve assets			
--deposits not included in official reserve assets			
--loans not included in official reserve assets			
--financial derivatives not included in official reserve assets			
--gold not included in official reserve assets			
--other			

II. Predetermined short-term net drains on foreign currency assets (nominal value)

			Maturity breakdown (residual maturity)		
		Total	Up to 1 month	More than 1 and up to 3 months	More than 3 months and up to 1 year
1. Foreign currency loans, securities, and deposits					
--outflows (-)	Principal				
	Interest				
--inflows (+)	Principal				
	Interest				
2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the domestic currency (including the forward leg of currency swaps)					
(a) Short positions (-) [4]		-62,000	-62,000		
(b) Long positions (+)					
3. Other (specify)					
--outflows related to repos (-)					
--inflows related to reverse repos (+)					
--trade credit (-)					
--trade credit (+)					
--other accounts payable (-)					
--other accounts receivable (+)					

III. Contingent short-term net drains on foreign currency assets (nominal value)

		Maturity breakdown (residual maturity, where applicable)		
	Total	Up to 1 month	More than 1 and up to 3 months	More than 3 months and up to 1 year
1. Contingent liabilities in foreign currency				
(a) Collateral guarantees on debt falling due within 1 year				
(b) Other contingent liabilities				
2. Foreign currency securities issued with embedded options (puttable bonds)				
3. Undrawn, unconditional credit lines provided by:				
(a) other national monetary authorities, BIS, IMF, and other international organizations				
--other national monetary authorities (+)				
--BIS (+)				
--IMF (+)				
(b) with banks and other financial institutions headquartered in the reporting country (+)				
(c) with banks and other financial institutions headquartered outside the reporting country (+)				
Undrawn, unconditional credit lines provided to:				
(a) other national monetary authorities, BIS, IMF, and other international organizations				
--other national monetary authorities (-)				

--BIS (-)				
--IMF (-)				
(b) banks and other financial institutions headquartered in reporting country (-)				
(c) banks and other financial institutions headquartered outside the reporting country (-)				
4. Aggregate short and long positions of options in foreign currencies vis-à-vis the domestic currency				
(a) Short positions				
(i) Bought puts				
(ii) Written calls				
(b) Long positions				
(i) Bought calls				
(ii) Written puts				
PRO MEMORIA: In-the-money options [11]				
(1) At current exchange rate				
(a) Short position				
(b) Long position				
(2) + 5 % (depreciation of 5%)				
(a) Short position				
(b) Long position				
(3) - 5 % (appreciation of 5%)				
(a) Short position				
(b) Long position				
(4) +10 % (depreciation of 10%)				
(a) Short position				
(b) Long position				
(5) - 10 % (appreciation of 10%)				
(a) Short position				
(b) Long position				
(6) Other (specify)				
(a) Short position				
(b) Long position				

IV. Memo items

(1) To be reported with standard periodicity and timeliness:	
(a) short-term domestic currency debt indexed to the exchange rate	
(b) financial instruments denominated in foreign currency and settled by other means (e.g., in domestic currency)	
--nondeliverable forwards	
--short positions	
--long positions	
--other instruments	
(c) pledged assets	
--included in reserve assets	
--included in other foreign currency assets	
(d) securities lent and on repo	7,140

--lent or repoed and included in Section I	
--lent or repoed but not included in Section I	
--borrowed or acquired and included in Section I	
--borrowed or acquired but not included in Section I	7,140
(e) financial derivative assets (net, marked to market)	
--forwards	
--futures	
--swaps	
--options	
--other	
(f) derivatives (forward, futures, or options contracts) that have a residual maturity greater than one year, which are subject to margin calls.	
--aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the domestic currency (including the forward leg of currency swaps)	
(a) short positions (–)	
(b) long positions (+)	
--aggregate short and long positions of options in foreign currencies vis-à-vis the domestic currency	
(a) short positions	
(i) bought puts	
(ii) written calls	
(b) long positions	
(i) bought calls	
(ii) written puts	
(2) To be disclosed less frequently:	
(a) currency composition of reserves (by groups of currencies)	75,704
--currencies in SDR basket	75,704
--currencies not in SDR basket	
--by individual currencies (optional)	

Notes:

1/ Includes holdings of the Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve's System Open Market Account (SOMA), valued at current market exchange rates. Foreign currency holdings listed as securities reflect marked-to-market values, and deposits reflect carrying values.

2/ The items, "2. IMF Reserve Position" and "3. Special Drawing Rights (SDRs)," are based on data provided by the IMF and are valued in dollar terms at the official SDR/dollar exchange rate for the reporting date. The entries for the latest week reflect any necessary adjustments, including revaluation, by the U.S. Treasury to IMF data for the prior month end.

3/ Gold stock is valued monthly at $42.2222 per fine troy ounce.

4/ The short positions reflect foreign exchange acquired under reciprocal currency arrangements with certain foreign central banks. The foreign exchange acquired is not included in Section I, "official reserve assets and other foreign currency assets," of the template for reporting international reserves. However, it is included in the broader balance of payments presentation as "U.S. Government assets, other than official reserve assets/U.S. foreign currency holdings and U.S. short-term assets."

PRESS ROOM

July 31, 2008
2008-7-31-16-39-9-6058

U.S. International Reserve Position

The Treasury Department today released U.S. reserve assets data for the latest week. As indicated in this table, U.S. reserve assets totaled $75,704 million as of the end of that week, compared to $75,855 million as of the end of the prior week.

I. Official reserve assets and other foreign currency assets (approximate market value, in US millions)

	July 18, 2008		
A. Official reserve assets (in US millions unless otherwise specified) [1]	Euro	Yen	Total
(1) Foreign currency reserves (in convertible foreign currencies)			75,704
(a) Securities	10,159	12,014	22,174
of which: issuer headquartered in reporting country but located abroad			0
(b) total currency and deposits with:			
(i) other national central banks, BIS and IMF	14,572	5,910	20,482
ii) banks headquartered in the reporting country			0
of which: located abroad			0
(iii) banks headquartered outside the reporting country			0
of which: located in the reporting country			0
(2) IMF reserve position [2]	5,154		
(3) SDRs [2]	9,855		
(4) gold (including gold deposits and, if appropriate, gold swapped) [3]	11,041		
--volume in millions of fine troy ounces	261.499		
(5) other reserve assets (specify)	6,998		
--financial derivatives			
--loans to nonbank nonresidents			
--other (foreign currency assets invested through reverse repurchase agreements)	6,998		
B. Other foreign currency assets (specify)			
--securities not included in official reserve assets			
--deposits not included in official reserve assets			
--loans not included in official reserve assets			
--financial derivatives not included in official reserve assets			
--gold not included in official reserve assets			
--other			

II. Predetermined short-term net drains on foreign currency assets (nominal value)

			Maturity breakdown (residual maturity)		
		Total	Up to 1 month	More than 1 and up to 3 months	More than 3 months and up to 1 year
1. Foreign currency loans, securities, and deposits					
--outflows (-)	Principal				
	Interest				
--inflows (+)	Principal				
	Interest				
2. Aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the domestic currency (including the forward leg of currency swaps)					
(a) Short positions (-) [4]		-62,000	-62,000		
(b) Long positions (+)					
3. Other (specify)					
--outflows related to repos (-)					
--inflows related to reverse repos (+)					
--trade credit (-)					
--trade credit (+)					
--other accounts payable (-)					
--other accounts receivable (+)					

III. Contingent short-term net drains on foreign currency assets (nominal value)

		Maturity breakdown (residual maturity, where applicable)		
	Total	Up to 1 month	More than 1 and up to 3 months	More than 3 months and up to 1 year
1. Contingent liabilities in foreign currency				
(a) Collateral guarantees on debt falling due within 1 year				
(b) Other contingent liabilities				
2. Foreign currency securities issued with embedded options (puttable bonds)				
3. Undrawn, unconditional credit lines provided by:				
(a) other national monetary authorities, BIS, IMF, and other international organizations				
--other national monetary authorities (+)				
--BIS (+)				
--IMF (+)				
(b) with banks and other financial institutions headquartered in the reporting country (+)				
(c) with banks and other financial institutions headquartered outside the reporting country (+)				
Undrawn, unconditional credit lines provided to:				
(a) other national monetary authorities, BIS, IMF, and other international organizations				
--other national monetary authorities (-)				

--BIS (-)				
--IMF (-)				
(b) banks and other financial institutions headquartered in reporting country (-)				
(c) banks and other financial institutions headquartered outside the reporting country (-)				
4. Aggregate short and long positions of options in foreign currencies vis-à-vis the domestic currency				
(a) Short positions				
(i) Bought puts				
(ii) Written calls				
(b) Long positions				
(i) Bought calls				
(ii) Written puts				
PRO MEMORIA: In-the-money options [1]				
(1) At current exchange rate				
(a) Short position				
(b) Long position				
(2) + 5 % (depreciation of 5%)				
(a) Short position				
(b) Long position				
(3) - 5 % (appreciation of 5%)				
(a) Short position				
(b) Long position				
(4) +10 % (depreciation of 10%)				
(a) Short position				
(b) Long position				
(5) - 10 % (appreciation of 10%)				
(a) Short position				
(b) Long position				
(6) Other (specify)				
(a) Short position				
(b) Long position				

IV. Memo items

(1) To be reported with standard periodicity and timeliness:	
(a) short-term domestic currency debt indexed to the exchange rate	
(b) financial instruments denominated in foreign currency and settled by other means (e.g., in domestic currency)	
--nondeliverable forwards	
--short positions	
--long positions	
--other instruments	
(c) pledged assets	
--included in reserve assets	
--included in other foreign currency assets	
(d) securities lent and on repo	7,140

--lent or repoed and included in Section I	
--lent or repoed but not included in Section I	
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(e) financial derivative assets (net, marked to market)	
--forwards	
--futures	
--swaps	
--options	
--other	
(f) derivatives (forward, futures, or options contracts) that have a residual maturity greater than one year, which are subject to margin calls.	
--aggregate short and long positions in forwards and futures in foreign currencies vis-à-vis the domestic currency (including the forward leg of currency swaps)	
(a) short positions (–)	
(b) long positions (+)	
--aggregate short and long positions of options in foreign currencies vis-à-vis the domestic currency	
(a) short positions	
(i) bought puts	
(ii) written calls	
(b) long positions	
(i) bought calls	
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(2) To be disclosed less frequently:	
(a) currency composition of reserves (by groups of currencies)	75,704
--currencies in SDR basket	75,704
--currencies not in SDR basket	
--by individual currencies (optional)	

Notes:

1/ Includes holdings of the Treasury's Exchange Stabilization Fund (ESF) and the Federal Reserve's System Open Market Account (SOMA), valued at current market exchange rates. Foreign currency holdings listed as securities reflect marked-to-market values, and deposits reflect carrying values.

2/ The items, "2. IMF Reserve Position" and "3. Special Drawing Rights (SDRs)," are based on data provided by the IMF and are valued in dollar terms at the official SDR/dollar exchange rate for the reporting date. The entries for the latest week reflect any necessary adjustments, including revaluation, by the U.S. Treasury to IMF data for the prior month end.

3/ Gold stock is valued monthly at $42.2222 per fine troy ounce.

4/ The short positions reflect foreign exchange acquired under reciprocal currency arrangements with certain foreign central banks. The foreign exchange acquired is not included in Section I, "official reserve assets and other foreign currency assets," of the template for reporting international reserves. However, it is included in the broader balance of payments presentation as "U.S. Government assets, other than official reserve assets/U.S. foreign currency holdings and U.S. short-term assets."