

[JOINT COMMITTEE PRINT]

**EXPLANATION OF PROPOSED
INCOME TAX TREATY BETWEEN
THE UNITED STATES AND
THE UNITED KINGDOM**

SCHEDULED FOR A HEARING
BEFORE THE
COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

ON MARCH 5, 2003

PREPARED BY THE STAFF
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CONTENTS

	Page
INTRODUCTION	1
I. SUMMARY	2
II. OVERVIEW OF U.S. TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES	4
A. U.S. Tax Rules	4
B. U.S. Tax Treaties	5
III. EXPLANATION OF PROPOSED TREATY	8
Article 1. General Scope	8
Article 2. Taxes Covered	13
Article 3. General Definitions	13
Article 4. Residence	16
Article 5. Permanent Establishment	18
Article 6. Income from Real Property	19
Article 7. Business Profits	20
Article 8. Shipping and Air Transport	25
Article 9. Associated Enterprises	26
Article 10. Dividends	27
Article 11. Interest	34
Article 12. Royalties	36
Article 13. Gains	38
Article 14. Income from Employment	39
Article 15. Directors' Fees	40
Article 16. Entertainers and Sportsmen	41
Article 17. Pensions, Social Security, Annuities, Ali- mony, and Child Support	41
Article 18. Pension Schemes	43
Article 19. Government Service	44
Article 20. Students	45
Article 20A. Teachers	45
Article 21. Offshore Exploration and Exploitation Activities	46
Article 22. Other Income	46
Article 23. Limitation on Benefits	47
Article 24. Relief From Double Taxation	56
Article 25. Non-Discrimination	62
Article 26. Mutual Agreement Procedure	64
Article 27. Exchange of Information and Adminis- trative Assistance	66
Article 28. Diplomatic Agents and Consular Offi- cers	68
Article 29. Entry into Force	68
Article 30. Termination	69
IV. ISSUES	71

IV

	Page
A. Zero Rate of Withholding Tax on Dividends from 80-Percent-Owned Subsidiaries	71
B. Anti-Conduit Rule	76
C. Insurance Excise Tax	78
D. Dividend Substitute Payments	79
E. Attribution of Business Profits	82
F. Income from the Rental of Ships and Aircraft	87
G. Creditability of U.K. Petroleum Revenue Tax	87
H. Teachers, Students, and Trainees	91

INTRODUCTION

This pamphlet,¹ prepared by the staff of the Joint Committee on Taxation, describes the proposed income tax treaty between the United States of America and the United Kingdom, as supplemented by an exchange of diplomatic notes (the “notes”) and a protocol (the “proposed protocol”). The proposed treaty and notes were signed on July 24, 2001. The proposed protocol was signed on July 22, 2002. Unless otherwise specified, the proposed treaty, the notes, and the proposed protocol are hereinafter referred to collectively as the “proposed treaty.” The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed treaty for March 5, 2003.²

Part I of the pamphlet provides a summary of the proposed treaty. Part II provides a brief overview of U.S. tax laws relating to international trade and investment and of U.S. income tax treaties in general. Part III contains an article-by-article explanation of the proposed treaty. Part IV contains a discussion of issues relating to the proposed treaty.

¹This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and the United Kingdom* (JCS-4-03), March 3, 2003.

²For a copy of the proposed treaty, see Senate Treaty Doc. 107-19.

I. SUMMARY

The principal purposes of the proposed treaty are to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country and to prevent avoidance or evasion of the taxes of the two countries. The proposed treaty also is intended to promote close economic cooperation between the two countries and to eliminate possible barriers to trade and investment caused by overlapping taxing jurisdictions of the two countries.

As in other U.S. tax treaties, these objectives principally are achieved through each country's agreement to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other country. For example, the proposed treaty contains provisions under which each country generally agrees not to tax business income derived from sources within that country by residents of the other country unless the business activities in the taxing country are substantial enough to constitute a permanent establishment (Article 7). Similarly, the proposed treaty contains "commercial visitor" exemptions under which residents of one country performing personal services in the other country will not be required to pay tax in the other country unless their contact with the other country exceeds specified minimums (Articles 14 and 16). The proposed treaty provides that dividends, interest, royalties, and certain capital gains derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles 10, 11, 12, and 13); however, the rate of tax that the source country may impose on a resident of the other country on dividends, interest, and royalties may be limited or eliminated by the proposed treaty (Articles 10, 11, and 12). In the case of dividends, the proposed treaty contains provisions that for the first time in a U.S. income tax treaty would eliminate source-country tax on certain dividends in which certain ownership thresholds and other requirements are satisfied.

In situations in which the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the proposed treaty generally provides for relief from the potential double taxation through the allowance by the country of residence of a tax credit for certain foreign taxes paid to the other country (Article 24).

The proposed treaty contains the standard provision (the "saving clause") included in U.S. tax treaties pursuant to which each country retains the right to tax its residents and citizens as if the treaty had not come into effect (Article 1). In addition, the proposed treaty contains the standard provision providing that the treaty may not be applied to deny any taxpayer any benefits the taxpayer would be entitled under the domestic law of a country or under any other agreement between the two countries (Article 1).

The proposed treaty contains provisions which can operate to deny the benefits of the dividends article (Article 10), the interest article (Article 11), the royalties article (Article 12), the other income article (Article 22), and the insurance excise tax provision of the business profits article (Article 7(5)) with respect to amounts paid under, or as part of, a conduit arrangement. The proposed treaty also contains a detailed limitation on benefits provision to prevent the inappropriate use of the treaty by third-country residents (Article 23).

The United States and the United Kingdom have an income tax treaty currently in force (signed in 1975). The proposed treaty is similar to other recent U.S. income tax treaties, the 1996 U.S. model income tax treaty ("U.S. model"), and the 1992 model income tax treaty of the Organization for Economic Cooperation and Development, as updated ("OECD model"). However, the proposed treaty contains certain substantive deviations from these treaties and models.

II. OVERVIEW OF U.S. TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES

This overview briefly describes certain U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. This overview also discusses the general objectives of U.S. tax treaties and describes some of the modifications to U.S. tax rules made by treaties.

A. U.S. Tax Rules

The United States taxes U.S. citizens, residents, and corporations on their worldwide income, whether derived in the United States or abroad. The United States generally taxes nonresident alien individuals and foreign corporations on all their income that is effectively connected with the conduct of a trade or business in the United States (sometimes referred to as “effectively connected income”). The United States also taxes nonresident alien individuals and foreign corporations on certain U.S.-source income that is not effectively connected with a U.S. trade or business.

Income of a nonresident alien individual or foreign corporation that is effectively connected with the conduct of a trade or business in the United States generally is subject to U.S. tax in the same manner and at the same rates as income of a U.S. person. Deductions are allowed to the extent that they are related to effectively connected income. A foreign corporation also is subject to a flat 30-percent branch profits tax on its “dividend equivalent amount,” which is a measure of the effectively connected earnings and profits of the corporation that are removed in any year from the conduct of its U.S. trade or business. In addition, a foreign corporation is subject to a flat 30-percent branch-level excess interest tax on the excess of the amount of interest that is deducted by the foreign corporation in computing its effectively connected income over the amount of interest that is paid by its U.S. trade or business.

U.S.-source fixed or determinable annual or periodical income of a nonresident alien individual or foreign corporation (including, for example, interest, dividends, rents, royalties, salaries, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to U.S. tax at a rate of 30 percent of the gross amount paid. Certain insurance premiums earned by a nonresident alien individual or foreign corporation are subject to U.S. tax at a rate of 1 or 4 percent of the premiums. These taxes generally are collected by means of withholding.

Specific statutory exemptions from the 30-percent withholding tax are provided. For example, certain original issue discount and certain interest on deposits with banks or savings institutions are exempt from the 30-percent withholding tax. An exemption also is provided for certain interest paid on portfolio debt obligations. In

addition, income of a foreign government or international organization from investments in U.S. securities is exempt from U.S. tax.

U.S.-source capital gains of a nonresident alien individual or a foreign corporation that are not effectively connected with a U.S. trade or business generally are exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien individual who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the disposition of interests in U.S. real property.

Rules are provided for the determination of the source of income. For example, interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation generally are considered U.S.-source income. Conversely, dividends and interest paid by a foreign corporation generally are treated as foreign-source income. Special rules apply to treat as foreign-source income (in whole or in part) interest paid by certain U.S. corporations with foreign businesses and to treat as U.S.-source income (in whole or in part) dividends paid by certain foreign corporations with U.S. businesses. Rents and royalties paid for the use of property in the United States are considered U.S.-source income.

Because the United States taxes U.S. citizens, residents, and corporations on their worldwide income, double taxation of income can arise when income earned abroad by a U.S. person is taxed by the country in which the income is earned and also by the United States. The United States seeks to mitigate this double taxation generally by allowing U.S. persons to credit foreign income taxes paid against the U.S. tax imposed on their foreign-source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax liability on U.S.-source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign-source income. The foreign tax credit limitation generally is computed on a worldwide basis (as opposed to a “per-country” basis). The limitation is applied separately for certain classifications of income. In addition, a special limitation applies to the credit for foreign taxes imposed on foreign oil and gas extraction income.

For foreign tax credit purposes, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation (or is otherwise required to include in its income earnings of the foreign corporation) is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid and its foreign tax credit limitation calculations for the year in which the dividend is received.

B. U.S. Tax Treaties

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. Another related objective of U.S. tax treaties is the removal of the barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person’s contacts with, and income derived from,

that jurisdiction are minimal. To a large extent, the treaty provisions designed to carry out these objectives supplement U.S. tax law provisions having the same objectives; treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty partner.

The objective of limiting double taxation generally is accomplished in treaties through the agreement of each country to limit, in specified situations, its right to tax income earned from its territory by residents of the other country. For the most part, the various rate reductions and exemptions agreed to by the source country in treaties are premised on the assumption that the country of residence will tax the income at levels comparable to those imposed by the source country on its residents. Treaties also provide for the elimination of double taxation by requiring the residence country to allow a credit for taxes that the source country retains the right to impose under the treaty. In addition, in the case of certain types of income, treaties may provide for exemption by the residence country of income taxed by the source country.

Treaties define the term “resident” so that an individual or corporation generally will not be subject to tax as a resident by both the countries. Treaties generally provide that neither country will tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a permanent establishment or fixed base in that jurisdiction. Treaties also contain commercial visitation exemptions under which individual residents of one country performing personal services in the other will not be required to pay tax in that other country unless their contacts exceed certain specified minimums (e.g., presence for a set number of days or earnings in excess of a specified amount). Treaties address passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country either by providing that such income is taxed only in the recipient’s country of residence or by reducing the rate of the source country’s withholding tax imposed on such income. In this regard, the United States agrees in its tax treaties to reduce its 30-percent withholding tax (or, in the case of some income, to eliminate it entirely) in return for reciprocal treatment by its treaty partner.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect. The United States also provides in its treaties that it will allow a credit against U.S. tax for income taxes paid to the treaty partners, subject to the various limitations of U.S. law.

The objective of preventing tax avoidance and evasion generally is accomplished in treaties by the agreement of each country to exchange tax-related information. Treaties generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information that is not obtainable under its laws or in the normal course of its administration

or that would reveal trade secrets or other information the disclosure of which would be contrary to public policy. The Internal Revenue Service (the “IRS”), and the treaty partner’s tax authorities, also can request specific tax information from a treaty partner. This can include information to be used in a criminal investigation or prosecution.

Administrative cooperation between countries is enhanced further under treaties by the inclusion of a “competent authority” mechanism to resolve double taxation problems arising in individual cases and, more generally, to facilitate consultation between tax officials of the two governments.

Treaties generally provide that neither country may subject nationals of the other country (or permanent establishments of enterprises of the other country) to taxation more burdensome than that it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither treaty country may discriminate against enterprises owned by residents of the other country.

At times, residents of countries that do not have income tax treaties with the United States attempt to use a treaty between the United States and another country to avoid U.S. tax. To prevent third-country residents from obtaining treaty benefits intended for treaty country residents only, treaties generally contain an “anti-treaty shopping” provision that is designed to limit treaty benefits to bona fide residents of the two countries.

III.

EXPLANATION OF PROPOSED TREATY

Article 1. General Scope

Overview

The general scope article describes the persons who may claim the benefits of the proposed treaty. It also includes a “saving clause” provision similar to provisions found in most U.S. income tax treaties.

The proposed treaty generally applies to residents of the United States and to residents of the United Kingdom, with specific modifications to such scope provided in other articles (*e.g.*, Article 19 (Government Service), Article 25 (Non-Discrimination), and Article 26 (Exchange of Information)). This scope is consistent with the scope of other U.S. income tax treaties, the U.S. model, and the OECD model. For purposes of the proposed treaty, residence is determined under Article 4 (Resident).

The proposed treaty provides that it does not restrict in any manner any benefit accorded by internal law or by any other agreement between the United States and the United Kingdom. Thus, the proposed treaty will not apply to increase the tax burden of a resident of either the United States or the United Kingdom. According to the Treasury Department’s Technical Explanation (hereinafter referred to as the “Technical Explanation”), the fact that the proposed treaty only applies to a taxpayer’s benefit does not mean that a taxpayer may select inconsistently among treaty and internal law provisions in order to minimize its overall tax burden. In this regard, the Technical Explanation sets forth the following example. Assume a resident of the United Kingdom has three separate businesses in the United States. One business is profitable and constitutes a U.S. permanent establishment. The other two businesses generate effectively connected income as determined under the Internal Revenue Code (the “Code”), but do not constitute permanent establishments as determined under the proposed treaty; one business is profitable and the other business generates a net loss. Under the Code, all three businesses would be subject to U.S. income tax, in which case the losses from the unprofitable business could offset the taxable income from the other businesses. On the other hand, only the income of the business which gives rise to a permanent establishment is taxable by the United States under the proposed treaty. The Technical Explanation makes clear that the taxpayer may not invoke the proposed treaty to exclude the profits of the profitable business that does not constitute a permanent establishment and invoke U.S. internal law to claim the loss of the unprofitable business that does not con-

stitute a permanent establishment to offset the taxable income of the permanent establishment.³

The proposed treaty provides that the dispute resolution procedures under its mutual agreement article (Article 26) take precedence over the corresponding provisions of any other agreement to which the United States and the United Kingdom are parties in determining whether a taxation measure is within the scope of the proposed treaty. The proposed treaty also provides that the dispute resolution procedures set forth in Article II and Article XVII of the General Agreement on Trade in Services (“GATS”) shall not apply to any taxation measure unless the competent authorities agree that the measure is not within the scope of the non-discrimination provisions of Article 25 (Non-Discrimination) of the proposed treaty. The Technical Explanation clarifies that no national treatment or most-favored nation obligations undertaken by the United States and the United Kingdom pursuant to GATS will apply to a taxation measure, unless the competent authorities otherwise agree.^{3A} For purposes of this provision, the term “measure” means a law, regulation, rule, procedure, decision, administrative action, or any similar provision or action.

The Technical Explanation points out that, unlike the U.S. model, the proposed treaty does not include an additional limitation on the application of other agreements between the United States and the United Kingdom that impose national treatment or most-favored nation obligations.⁴ According to the notes and the Technical Explanation, instead of generally limiting the effect of other such agreements, the United States and the United Kingdom analyzed existing agreements and believe that the only such agreements in force between the countries are: GATS; the General Agreement on Tariffs and Trade; the Convention to Regulate the Commerce between the Territories of the United States and of his Britannic Majesty, signed in London on July 3, 1815; and the Treaty of Amity, Commerce, and Navigation, between his Britannic Majesty and the United States of America, signed at London, November 19, 1794. The Technical Explanation states that these agreements (other than GATS, as described in the preceding paragraph) are unlikely ever to apply with respect to an income tax provision.

There are two ways in which the absence of the U.S. model provision affects the implementation of this provision. The first is the interaction of the proposed treaty with these three⁵ agreements, should they apply with respect to an income tax provision. According to the Technical Explanation: (1) if one of the three agreements overlaps with Article 25 (Non-Discrimination) of the proposed treaty, remedies would be available under both agreements; (2) if benefits are available under one of the three agreements but not under Article 25, a resident is entitled to the benefits under the applicable agreement; and (3) if benefits are available under Article 25 but

³ See Rev. Rul. 84-17, 1984-1 C.B. 308.

^{3A} It is unclear whether this statement in the Technical Explanation encompasses all interaction between GATS and the proposed treaty.

⁴ The Technical Explanation does not explain the rationale for this variation from the U.S. model.

⁵ The four agreements listed in the notes and Technical Explanation, except for GATS. The interaction of GATS with the proposed treaty is described in the second preceding paragraph.

not under one of the three agreements, a resident is entitled to the benefits under Article 25. These rules, as articulated in the Technical Explanation, may be more burdensome to apply than would be the case if the U.S. model rule had been incorporated. In addition, if it were determined that there is in fact overlap between the proposed treaty and the General Agreement on Tariffs and Trade, the consequences may be more severe than they would be with respect to the 1815 and 1794 agreements, because those two agreements are bilateral, while the General Agreement on Tariffs and Trade is multilateral.

The second is the interaction of the proposed treaty with any other agreements in effect between the two treaty countries that were not listed. It is uncertain that the agreements enumerated in the notes and Technical Explanation constitute the complete and exhaustive list.⁶ Accordingly, the Technical Explanation states that the treaty countries will consult with a view to ensuring the proper interaction of the proposed treaty and any other relevant agreements in force that are determined at the time of the signing of the proposed treaty to include obligations with respect to taxation measures. The Technical Explanation also states that such consultation may result in an amendment to the proposed treaty if necessary but, unless and until such an amendment is made, any other agreement between the treaty countries would apply concurrently with the proposed treaty. The Technical Explanation does not clarify how to resolve the concurrent application of conflicting provisions in the proposed treaty and the other agreement should both provisions apply with respect to an income tax provision.

It is unclear why the notes and Technical Explanation include references to other agreements that the Technical Explanation states are unlikely ever to apply with respect to an income tax provision. In order to assure itself that this provision is not utilized in unintended or unforeseen ways in the future, the Committee may wish to instruct the Secretary of the Treasury to report to the Committee regarding every instance in which the Treasury or the IRS is aware that a taxpayer claims any income tax benefit outside of the proposed treaty but under any of these agreements or under any other agreements not listed in the notes and Technical Explanation.

Saving clause

Like all U.S. income tax treaties and the U.S. Model, the proposed treaty includes a “saving clause.” Under this clause, with specific exceptions described below, the proposed treaty does not affect the taxation by either treaty country of its residents or its citizens. By reason of this saving clause, unless otherwise specifically provided in the proposed treaty, the United States may continue to tax its citizens who are residents of the United Kingdom as if the treaty were not in force. For purposes of the proposed treaty (and, thus, for purposes of the saving clause), the term “residents,” which is defined in Article 4 (Resident), includes corporations and other entities as well as individuals.

⁶The Technical Explanation states that “the Contracting States *believe* that the only agreements. . . .” (emphasis added).

The proposed treaty contains a provision under which the saving clause (and therefore the U.S. jurisdiction to tax) applies to a former U.S. citizen or long-term resident (whether or not treated as such under Article 4 (Resident)), whose loss of citizenship or resident status, respectively, had as one of its principal purposes the avoidance of tax; such application is limited to the ten-year period following the loss of citizenship or resident status. The proposed treaty provides that this provision does not apply to former citizens or residents who relinquished such status at any time before February 6, 1995. The Technical Explanation states that this date is consistent with the effective date of amendments to Section 877 of the Code that were made by the Health and Insurance Accountability and Portability Act of 1996, section 511 (Public Law 104–191). As amended, Section 877 provides special rules for the imposition of U.S. income tax on former U.S. citizens and long-term residents for a period of ten years following the loss of citizenship; these special tax rules apply to a former citizen or long-term resident only if his or her loss of U.S. citizenship or resident status had as one of its principal purposes the avoidance of U.S. income, estate, or gift taxes. For purposes of applying the special tax rules to former citizens and long-term residents, individuals who meet a specified income tax liability threshold or a specified net worth threshold generally are considered to have lost citizenship or resident status for a principal purpose of U.S. tax avoidance.

For purposes of the proposed treaty, the United States and the United Kingdom have agreed in the notes that an individual is considered a “long-term resident” of a treaty country only if the individual (other than a citizen of that country) was a lawful permanent resident of that country in at least 8 of the 15 taxable years ending with the taxable year in which the individual ceased to be a long-term resident. The Technical Explanation states that this standard is consistent with U.S. domestic law. The notes also provide several factors that shall be considered favorably in determining whether or not one of the principal purposes of an individual’s loss of citizenship of either treaty country was the avoidance of tax. These factors generally are consistent with U.S. domestic law.

Exceptions to the saving clause are provided for the following benefits conferred by a treaty country: the allowance of correlative adjustments when the profits of an associated enterprise are adjusted by the other country (Article 9, paragraph 2); the exemption from source- and residence-country tax for certain pension, social security, alimony, and child support payments (Article 17, paragraphs 1(b), 3 and 5); the exemption from source- and residence-country tax for certain investment income of pension schemes established in the other treaty country (Article 18, paragraphs 1 and 5); relief from double taxation through the provision of a foreign tax credit (Article 24); protection from discriminatory tax treatment with respect to transactions with residents of the other country (Article 25); and benefits under the mutual agreement procedures (Article 26). These exceptions to the saving clause permit residents or citizens of the United States or the United Kingdom to obtain such benefits of the proposed treaty with respect to their country of residence or citizenship.

In addition, the saving clause does not apply to certain benefits conferred by one of the countries upon individuals who neither are citizens of that country nor have been admitted for permanent residence in that country. Under this set of exceptions to the saving clause, the specified treaty benefits are available to, for example, a citizen of the United Kingdom who spends enough time in the United States to be taxed as a U.S. resident but who has not acquired U.S. permanent residence status (*i.e.*, does not hold a “green card”). The benefits that are covered under this set of exceptions are the beneficial host-country tax treatment of pension fund contributions (paragraph 2 of Article 18), as well as the exemptions from host country tax for certain compensation from government service (Article 19), certain income received by visiting students and trainees (Article 20), certain income received by visiting teachers (Article 20A), and certain income of diplomats and consular officials (Article 28).

Fiscally transparent entities

The proposed treaty contains special rules for fiscally transparent entities. Under these rules, income derived through an entity that is fiscally transparent under the laws of either treaty country is considered to be the income of a resident of one of the treaty countries only to the extent that the income is subject to tax in that country as the income of a resident. For example, if a U.K. company pays interest to an entity that is treated as fiscally transparent for U.S. tax purposes, the interest will be considered to be derived by a resident of the United States only to the extent that U.S. tax laws treat one or more U.S. residents (whose status as U.S. residents is determined under U.S. tax laws) as deriving the interest income for U.S. tax purposes.

The Technical Explanation states that these rules for income derived through fiscally transparent entities apply regardless of where the entity is organized (*i.e.*, in the United States, the United Kingdom, or a third country). The Technical Explanation also states that these rules apply even if the entity is viewed differently under the tax laws of the other country. As an example, the Technical Explanation states that income from U.S. sources received by an entity organized under the laws of the United States, which is treated for U.K. tax purposes as a corporation and is owned by a U.K. shareholder who is a U.K. resident for U.K. 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 proposed treaty, the income is treated as derived by the U.S. entity.

The Technical Explanation also states that the treatment of fiscally transparent entities is not an exception to the saving clause. Therefore, such treatment does not preclude a treaty country from taxing an entity that is treated as a resident of that country under its tax laws. For example, if a U.S. limited liability company (“LLC”) with U.K. members 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 the United Kingdom views the LLC as fiscally transparent. The diplomatic notes provide rules under Article 24 (Relief from Double Tax-

ation) for determining which treaty country has the primary right to tax income derived through a fiscally transparent entity and which treaty country must provide a credit for such taxes.

Article 2. Taxes Covered

The proposed treaty generally applies to the income and capital gains taxes of the United States and the United Kingdom. However, like the present treaty, Article 25 (Non-Discrimination) of the proposed treaty is applicable to all taxes imposed at all levels of government, including State and local taxes.

In the case of the United States, the proposed treaty applies to the Federal income taxes imposed by the Code, but excludes social security taxes. In addition, the proposed treaty applies to the U.S. excise taxes imposed on insurance premiums paid to foreign insurers and with respect to private foundations. Unlike the present treaty, but like the U.S. model, the proposed treaty applies to the accumulated earnings tax and the personal holding company tax.

The proposed treaty applies to the excise taxes on insurance premiums paid to foreign insurers. Because the insurance excise taxes are covered taxes under the proposed treaty, U.K. insurers generally are not subject to the U.S. excise taxes on insurance premiums for insuring U.S. risks. The excise taxes continue to apply, however, when a U.K. insurer reinsures a policy it has written on a U.S. risk with a foreign insurer that is not entitled to a similar exemption under this or a different tax treaty, in an arrangement with a main purpose of obtaining the benefits of the proposed treaty.

The notes state that it is understood that, if a political subdivision or local authority of the United States seeks to impose tax on the profits of any enterprise of the United Kingdom from the operation of ships or aircraft in international traffic, in circumstances where the proposed treaty would preclude the imposition of a Federal income tax on such profits, the United States Government will use its best endeavors to persuade the political subdivision or local authority to refrain from imposing tax.

In the case of the United Kingdom, the proposed treaty applies to the income tax; the capital gains tax; the corporation tax; and the petroleum revenue tax (subject to the limitations under paragraph 3 of Article 24 (Relief from Double Taxation) on the amount of petroleum revenue tax allowable as a credit against U.S. tax).

The proposed treaty also contains a rule generally found in U.S. income tax treaties (including the present treaty) that provides that the proposed treaty applies to any identical or substantially similar taxes that may be imposed subsequently in addition to or in place of the taxes covered. The proposed treaty obligates the competent authority of each country to notify the competent authority of the other country of any changes in its internal tax laws that significantly affect their obligations under the proposed treaty. The Technical Explanation states that this requirement relates to changes that are significant to the operation of the proposed treaty.

Article 3. General Definitions

The proposed treaty provides definitions of a number of terms for purposes of the proposed treaty. Certain of the standard definitions

found in most U.S. income tax treaties are included in the proposed treaty.

The term “person” includes an individual, an estate, a trust, a partnership, a company, and any other body of persons.

A “company” under the proposed treaty is any body corporate or any entity that is treated as a body corporate for tax purposes.

The term “enterprise” includes any activity or activities that constitute a trade or business, while the term “business” includes the performance of professional services and other activities of an independent character. The definitions of “enterprise” and “business” in the proposed treaty are identical to the same definitions recently added to the OECD Model in conjunction with the deletion of Article 14 (Independent Personal Services) from the OECD Model. The Technical Explanation states that the inclusion of these definitions is intended to clarify that the performance of personal services or other activities of an independent character are considered to constitute an enterprise, covered by Article 7 (Business Profits). By contrast, the U.S. Model does not provide definitions of the terms “enterprise” and “business” because, unlike the proposed treaty and the OECD Model, the U.S. Model continues to include a separate article concerning the treatment of independent personal services.

The terms “enterprise of a Contracting State” and “enterprise of the other Contracting State” mean, respectively, an enterprise carried on by a resident of a treaty country and an enterprise carried on by a resident of the other treaty country.

The proposed treaty defines “international traffic” as any transport by a ship or aircraft, except when the transport is solely between places in the other treaty country. Accordingly, with respect to a U.K. enterprise, purely domestic transport within the United States does not constitute “international traffic.”

The U.S. “competent authority” is the Secretary of the Treasury or his delegate. The U.S. competent authority function has been delegated to the Commissioner of Internal Revenue, who has re-delegated the authority to the Assistant Commissioner (International). On interpretative issues, the latter acts with the concurrence of the Associate Chief Counsel (International) of the IRS. The U.K. “competent authority” is the Commissioners of Inland Revenue or their authorized representative.

The term “United States” means the United States of America (including the States thereof and the District of Columbia), but does not include Puerto Rico, the Virgin Islands, Guam, or any other U.S. possession or territory. The term “United States” also includes the territorial sea of the United States and any area beyond the territorial sea that is designated as an area within which the United States, in compliance with its legislation and in conformity with international law, exercises sovereign rights in respect of the exploration and exploitation of the natural resources of the seabed, the subsoil, and the superjacent waters. The Technical Explanation states that the extension of the term to such areas applies only if the person, property, or activity to which the proposed treaty is being applied is connected with such natural resource exploration or exploitation.

The term “United Kingdom” means Great Britain and Northern Ireland, and includes any area outside the territorial sea of the

United Kingdom which has been or may hereafter be so designated, in accordance with international law and under the laws of the United Kingdom concerning the Continental Shelf, as an area within which the rights of the United Kingdom with respect to the sea bed and sub-soil and their natural resources may be exercised. The Technical Explanation states that the proposed treaty does not apply to the Channel Islands or the Isle of Man.

The term “national” means: (1) all individuals possessing the citizenship of a treaty country; and (2) all legal persons, partnerships, and associations deriving their status as such from the laws in force in a treaty country.

The proposed treaty defines the term “qualified governmental entity” as a treaty country, or a political subdivision or local authority of a treaty country. Also defined as a qualified governmental entity is a person that is wholly owned (directly or indirectly) by a treaty country or a political subdivision or local authority thereof, provided it is organized under the laws of a treaty country, its earnings are credited to its own account with no portion of its income inuring to the benefit of any private person, and its assets vest in the treaty country, political subdivision or local authority upon dissolution. The definition described in the previous sentence only applies if the entity does not carry on commercial activities. These definitions are the same as those in the U.S. model. However, unlike the U.S. model, the proposed treaty excludes from the definition of the term “qualified governmental entity” government pension funds. According to the Technical Explanation, a number of the benefits that are relevant only to government pension funds in the U.S. Model are available to all qualified pension funds under the proposed treaty.

The term “Contracting State” means the United States or the United Kingdom, as the context requires.

The proposed treaty defines the term “real property,” consistent with the definition provided in Treas. Reg. Sec. 1.897-1(b), to include: land and the unsevered products of the land (including property accessory to real property); improvements; personal property associated with the use of real property (such as livestock and equipment used in agriculture and forestry); rights to which the provisions of general law respecting landed property apply; usufructs of real property; and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources, and other natural resources. The term does not include an interest in land solely as a creditor. The term also does not include ships, boats, and aircraft.

The proposed treaty defines the term “conduit arrangement” as a transaction or series of transactions that meets both of the following criteria: (1) a resident of one contracting state receives an item of income that generally would qualify for treaty benefits, and then pays (directly or indirectly, at any time or in any form) all or substantially all of that income to a resident of a third state who would not be entitled to equivalent or greater treaty benefits if it had received the same item of income directly; and (2) obtaining the increased treaty benefits is the main purpose or one of the main purposes of the transaction or series of transactions.

The proposed treaty also contains the standard provision that, unless the context otherwise requires or the competent authorities agree upon a common meaning pursuant to Article 26 (Mutual Agreement Procedure), all terms not defined in the proposed treaty have the meaning pursuant to the respective tax laws of the country that is applying the treaty.

Article 4. Residence

The assignment of a country of residence is important because the benefits of the proposed treaty generally are available only to a resident of one of the treaty countries as that term is defined in the proposed treaty. Furthermore, issues arising because of dual residency, including situations of double taxation, may be avoided by the assignment of one treaty country as the country of residence when under the internal laws of the treaty countries a person is a resident of both countries.

Internal taxation rules

United States

Under U.S. law, the residence of an individual is important because a resident alien, like a U.S. citizen, is taxed on his or her worldwide income, while a nonresident alien is taxed only on certain U.S.-source income and on income that is effectively connected with a U.S. trade or business. An individual who spends sufficient time in the United States in any year or over a three-year period generally is treated as a U.S. resident. A permanent resident for immigration purposes (*i.e.*, a “green card” holder) also is treated as a U.S. resident.

Under U.S. law, a company is taxed on its worldwide income if it is a “domestic corporation.” A domestic corporation is one that is created or organized in the United States or under the laws of the United States, a State, or the District of Columbia.

United Kingdom

Under U.K. law, resident individuals are subject to tax on their worldwide income, while nonresident individuals generally are subject to tax only on income arising in the United Kingdom. However, resident individuals who are not domiciled in the United Kingdom generally are subject to U.K. tax on income from sources outside the United Kingdom only to the extent that the income is remitted to the United Kingdom. Individuals generally are considered residents of the United Kingdom if they are present for a sufficient time in any individual year or over a four-year period. Even if not present for a sufficient time, individuals may be treated as residents if they own or lease accommodations in the United Kingdom.

Companies that are resident in the United Kingdom are subject to tax on their worldwide income. A company is resident in the United Kingdom if it is incorporated under U.K. law or it is managed and controlled in the United Kingdom. Companies that are not resident in the United Kingdom are subject to corporate income tax on income derived from the United Kingdom.

Proposed treaty rules

The proposed treaty specifies rules to determine whether a person is a resident of the United States or the United Kingdom for purposes of the proposed treaty. The rules generally are consistent with the rules of the U.S. model.

The proposed treaty generally defines “resident of a Contracting State” to mean any person who, under the laws of that country, is liable to tax in that country by reason of the person’s domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature. The term “resident of a Contracting State” does not include any person that is liable to tax in that country only on income from sources in that country or on profits attributable to a permanent establishment in that country. The proposed treaty provides that the United Kingdom will treat an individual who is a U.S. citizen or lawful permanent resident of the United States (*i.e.*, a “green card” holder) as a resident of the United States only if he or she has a substantial presence, permanent home, or habitual abode in the United States and is not a resident of a third country for purposes of a tax treaty between such country and the United Kingdom. The determination of whether a citizen or national is considered a resident of the United States or the United Kingdom is made based on the principles of the treaty tie-breaker rules described below.

The proposed treaty treats as residents of a treaty country certain organizations that generally are exempt from tax in that country. Under these rules, a resident includes a legal person that is organized under the laws of a treaty country and is generally exempt from tax in the treaty country because it is established and maintained: (1) to provide pensions or other similar benefits to employees pursuant to a tax-exempt scheme or plan; (2) exclusively for a religious, charitable, scientific, artistic, cultural, or educational purposes; or (3) as a qualified governmental entity that is, is a part of, or is established in, that country.

The proposed treaty provides a set of “tie-breaker” rules to determine residence in the case of an individual who, under the basic residence definition, would be considered to be a resident of both countries. Under these rules, an individual is deemed to be a resident of the country in which he or she has a permanent home available. If the individual has a permanent home in both countries, the individual’s residence is deemed to be the country with which his or her personal and economic relations are closer (*i.e.*, his or her “center of vital interests”). If the country in which the individual has his or her center of vital interests cannot be determined, or if he or she does not have a permanent home available in either country, he or she is deemed to be a resident of the country in which he or she has an habitual abode. If the individual has an habitual abode in both countries or in neither country, he or she is deemed to be a resident of the country of which he or she is a national. If the individual is a national of both countries or neither country, the competent authorities of the countries will settle the question of residence by mutual agreement.

In the case of any person other than an individual that would be a resident of both countries, the proposed treaty requires the competent authorities to endeavor to settle the issue of residence by

mutual agreement and to determine the mode of application of the proposed treaty to such person.

Like the present treaty, the proposed treaty provides that, for U.K. tax purposes, the domicile of a woman who is a U.S. national and who was married before January 1, 1974 to a man domiciled in the United Kingdom is determined as if such marriage took place on January 1, 1974. Prior to January 1, 1974, the domicile of a woman was the same as the domicile of her husband under U.K. law. Although this law was repealed, a transitional rule provides that a woman who was married before 1974 is treated as retaining her husband's domicile unless and until she changes her domicile by acquisition or revival of another domicile after 1973. By providing a special tax rule for women who were married before 1974, the proposed treaty equalizes the treatment of male and female U.S. citizens who are married to spouses domiciled in the U.K.

Article 5. Permanent Establishment

The proposed treaty contains a definition of the term "permanent establishment" that generally follows the pattern of the present treaty, other recent U.S. income tax treaties, the U.S. model, and the OECD model.

The permanent establishment concept is one of the basic devices used in income tax treaties to limit the taxing jurisdiction of the host country and thus to mitigate double taxation. Generally, an enterprise that is a resident of one country is not taxable by the other country on its business profits unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the permanent establishment concept is used to determine whether the reduced rates of, or exemptions from, tax provided for dividends, interest, and royalties apply, or whether those items of income will be taxed as business profits.

In general, under the proposed treaty, a permanent establishment is a fixed place of business in which the business of an enterprise is wholly or partly carried on. A permanent establishment includes a place of management, a branch, an office, a factory, a workshop, a mine, a quarry, or other place of extraction of natural resources. It also includes a building site or construction or assembly project that continues for more than twelve months. The Technical Explanation states that the twelve-month test applies separately to each individual site or project, with a series of contracts or projects that are interdependent both commercially and geographically treated as a single project. The Technical Explanation further states that if the twelve-month threshold is exceeded, the site or project constitutes a permanent establishment as of the first day that work in the country began. The proposed treaty differs from the U.S. Model in that the general definition of a permanent establishment does not apply to offshore drilling rigs, which are governed by the special rules in Article 21 (Offshore Exploration and Exploitation Activities) concerning exploration and exploitation of natural resources.

Under the proposed treaty, as under the present treaty, the following activities are deemed not to constitute a permanent establishment: (1) the use of facilities solely for storing, displaying, or

delivering goods or merchandise belonging to the enterprise; (2) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for storage, display, or delivery or solely for processing by another enterprise; and (3) the maintenance of a fixed place of business solely for the purchase of goods or merchandise or for the collection of information for the enterprise. The proposed treaty also provides that the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character does not constitute a permanent establishment. The proposed treaty provides that a combination of these activities will not give rise to a permanent establishment, but only if the combination results in an overall activity that is of a preparatory or auxiliary character. This rule is derived from the OECD model but differs from the U.S. model, which provides that any combination of otherwise excepted activities is not deemed to give rise to a permanent establishment, without the additional requirement that the combination, as distinct from each individual activity, be preparatory or auxiliary. The Technical Explanation states that it is assumed that if preparatory or auxiliary activities are combined, the combination generally will also be of a preparatory or auxiliary character, but that a permanent establishment may result from a combination of such activities if this is not the case.

Under the proposed treaty, as under the present treaty, if a person, other than an independent agent, is acting in a treaty country on behalf of an enterprise of the other country and has, and habitually exercises in such first country, the authority to conclude contracts that are binding on such enterprise, the enterprise is deemed to have a permanent establishment in the first country in respect of any activities undertaken for that enterprise. This rule does not apply where the activities are limited to the purchase of goods or merchandise for the enterprise.

Under the proposed treaty, no permanent establishment is deemed to arise if the agent is a broker, general commission agent, or any other agent of independent status, provided that the agent is acting in the ordinary course of its business. The Technical Explanation states that whether an enterprise and an agent are independent is a factual determination, relevant factors of which include: (1) the extent to which the agent operates on the basis of instructions from the principal; (2) the extent to which the agent bears business risk; and (3) whether the agent has an exclusive or nearly exclusive relationship with the principal.

The proposed treaty provides that the fact that a company that is a resident of one country controls or is controlled by a company that is a resident of the other country or that carries on business in the other country does not of itself cause either company to be a permanent establishment of the other.

Article 6. Income From Real Property

This article covers income from real property. The rules covering gains from the sale of real property are included in Article 13 (Gains).

Under the proposed treaty, income derived by a resident of one country from real property situated in the other country may be

taxed in the country where the property is situated. This rule is consistent with the rules in the U.S. and OECD models. For this purpose, income from real property includes income from agriculture or forestry. The term “real property” is defined in paragraph (1)(m) of Article 3.

The proposed treaty specifies that the country in which the property is situated also may tax income derived from the direct use, letting, or use in any other form of real property. The rules of Article 6, permitting source-country taxation, also apply to the income from real property of an enterprise.

Article 7. Business Profits

Internal taxation rules

United States

U.S. law distinguishes between the U.S. business income and the other U.S. income of a nonresident alien or foreign corporation. A nonresident alien or foreign corporation is subject to a flat 30-percent rate (or lower treaty rate) of tax on certain U.S.-source income if that income is not effectively connected with the conduct of a trade or business within the United States. The regular individual or corporate rates apply to income (from any source) that is effectively connected with the conduct of a trade or business within the United States. The performance of personal services within the United States may constitute a trade or business within the United States.

The treatment of income as effectively connected with a U.S. trade or business depends upon whether the source of the income is U.S. or foreign. In general, U.S.-source periodic income (such as interest, dividends, rents, and wages) and U.S.-source capital gains are effectively connected with the conduct of a trade or business within the United States if the asset generating the income is used in (or held for use in) the conduct of the trade or business or if the activities of the trade or business were a material factor in the realization of the income. All other U.S.-source income of a person engaged in a trade or business in the United States is treated as effectively connected with the conduct of a trade or business in the United States (under what is referred to as a “force of attraction” rule).

The income of a nonresident alien individual from the performance of personal services within the United States is excluded from U.S.-source income, and therefore is not taxed by the United States in the absence of a U.S. trade or business, if the following criteria are met: (1) the individual is not in the United States for over 90 days during the taxable year; (2) the compensation does not exceed \$3,000; and (3) the services are performed as an employee of, or under a contract with, a foreign person not engaged in a trade or business in the United States, or are performed for a foreign office or place of business of a U.S. person.

Foreign-source income generally is effectively connected income only if the foreign person has an office or other fixed place of business in the United States and the income is attributable to that place of business. Only three types of foreign-source income are considered to be effectively connected income: rents and royalties

for the use of certain intangible property derived from the active conduct of a U.S. business; certain dividends and interest either derived in the active conduct of a banking, financing or similar business in the United States or received by a corporation the principal business of which is trading in stocks or securities for its own account; and certain sales income attributable to a U.S. sales office. Special rules apply for purposes of determining the foreign-source income that is effectively connected with a U.S. business of an insurance company.

Any income or gain of a foreign person for any taxable year that is attributable to a transaction in another year is treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in that other year (Code sec. 864(c)(6)). In addition, if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, the determination of whether any income or gain attributable to a sale or exchange of that property occurring within ten years after the cessation of business is effectively connected with the conduct of a trade or business within the United States is made as if the sale or exchange occurred immediately before the cessation of business (Code sec. 864(c)(7)).

An excise tax is imposed on insurance premiums paid to a foreign insurer or reinsurer with respect to U.S. risks. The rate of tax is either 4 percent or 1 percent. The rate of the excise tax is 4 percent of the premium on a policy of casualty insurance or indemnity bond that is (1) paid by a U.S. person on risks wholly or partly within the United States, or (2) paid by a foreign person on risks wholly within the United States. The rate of the excise tax is 1 percent of the premium paid on a policy of life, sickness or accident insurance, or an annuity contract. The rate of the excise tax is also 1 percent of any premium for reinsurance of any of the foregoing types of contracts.

Two exceptions to the application of the insurance excise tax are provided. One exception is for amounts that are effectively connected with the conduct of a U.S. trade or business (provided no treaty provision exempts the amounts from U.S. taxation). Thus, under this exception, the insurance excise tax does not apply to amounts that are subject to U.S. income tax in the hands of a foreign insurer or reinsurer pursuant to its election to be taxed as a domestic corporation under Code section 953(d), or pursuant to its election under Code section 953(c) to treat related person insurance income as effectively connected to the conduct of a U.S. trade or business. The other exception applies to premiums on an indemnity bond to secure certain pension and other payments by the United States government.

United Kingdom

Foreign corporations and nonresident individuals generally are subject to tax in the United Kingdom only on income arising in the United Kingdom. Business income derived in the United Kingdom by a foreign corporation or nonresident individual generally is taxed in the same manner as the income of a resident corporation or individual.

Proposed treaty limitations on internal law

Under the proposed treaty, business profits of an enterprise of one of the countries are taxable in the other country only to the extent that they are attributable to a permanent establishment in the other country through which the enterprise carries on business. This is one of the basic limitations on a country's right to tax income of a resident of the other country. The rule is similar to those contained in the U.S. and OECD models.

Although the proposed treaty does not provide a definition of the term "business profits," the Technical Explanation states that the term generally means income derived from any trade or business. This definition includes income from independent personal services, which, unlike the U.S. Model but like the OECD Model, is not addressed in a separate article. Although the proposed treaty does not include a separate article for independent personal services, this Article limits the right of a treaty country to tax income from the performance of personal services by a resident of the other treaty country in a manner similar to the limitations provided in the separate article applicable to independent personal services that is included in the U.S. Model and other U.S. treaties.

Because the definition of "business profits" includes independent personal services under the proposed treaty, the Technical Explanation states that the term 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 (e.g., notional principal contracts entered into for the purpose of hedging currency risk arising from an active trade or business). Any other income derived from financial instruments is addressed in Article 22 (Other Income), unless specifically governed by another article.

The Technical Explanation states that business profits also include income earned by an enterprise from the furnishing of personal services. For example, a U.S. consulting firm whose employees or partners perform services in the United Kingdom through a permanent establishment may be taxed in the United Kingdom on a net basis under this Article, rather than Article 14 (Income from Employment), consistent with the OECD Model. However, salaries of employees of the consulting firm would remain subject to Article 14 (Income from Employment). In addition, the Technical Explanation states that business profits include income derived by a partner of one treaty country that is attributable to personal services performed in the other treaty country through a partnership with a permanent establishment in that other country. Thus, income that may be taxed as business profits includes all income that is attributable to the permanent establishment with respect to the performance of personal services carried on by the partnership (whether by the partner himself, other partners in the partnership, or employees assisting the partners), as well as any income from activities that are ancillary to the performance of the services (e.g., charges for facsimile services). For example, if a U.K. partnership has four partners who are resident and perform personal services only in the U.K. office and one partner who performs personal services in a U.S. office that is a permanent establishment in the

United States (and the five partners agree to equally split profits), the four U.K. resident partners may be taxed in the United States with respect to their shares of the income that is attributable to the U.S. office. The services that generate the income attributable to the U.S. office would include the services performed by the partner in the U.S. office, as well as any income with respect to services performed on behalf of the U.K. office by a U.K. partner who travels to the United States and performs such services in the United States, regardless of whether the U.K. partner actually visited or used the U.S. office while performing the services in the United States.

The proposed treaty provides that there will be attributed to a permanent establishment the business profits which it might be expected to make if it were 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 and other associated enterprises. The Technical Explanation states that this rule permits the use of methods other than separate accounting to determine the arm's-length profits of a permanent establishment where it is necessary to do so for practical reasons, such as when the affairs of the permanent establishment are so closely bound up with those of the head office that it would be impossible to disentangle them on any strict basis of accounts.

In computing taxable business profits of a permanent establishment, the proposed treaty provides that deductions are allowed for expenses, wherever incurred, which are attributable to the activities of the permanent establishment. These deductions include an allocation of executive and general administrative expenses, as determined by applying the arm's-length principle and regardless of which accounting unit of the enterprise books the expenses, provided they are incurred for the purposes of the permanent establishment. The notes state that the OECD Transfer Pricing Guidelines apply by analogy in determining the profits attributable to a permanent establishment. Accordingly, any of the methods described in the guidelines (including profits methods) may be used in accordance with the guidelines to determine the income of a permanent establishment.

For purposes of determining the amount of profits that are attributable to a permanent establishment, the notes state that the permanent establishment is treated as having the same amount of capital that it would need to support its activities if it were a distinct and separate enterprise engaged in the same or similar activities. This means, for example, that a permanent establishment cannot be funded entirely with debt. To the extent that a permanent establishment does not have sufficient capital to carry on its activities as if it were a distinct and separate enterprise, a treaty country may attribute such capital to the permanent establishment and deny an interest deduction to the extent necessary to reflect that capital attribution. The Technical Explanation states that the amount of capital attributable to a permanent establishment that is a financial institution (other than an insurance company) is determined by allocating the institution's total equity among its var-

ious offices on the basis of the proportion of the institution's risk-weighted assets attributable to each of them.

Unlike the U.S. model and the OECD model, the proposed treaty does not include a rule providing that business profits are not attributed to a permanent establishment merely by reason of the purchase of goods or merchandise by the permanent establishment for the enterprise. This rule is only relevant to an office that performs functions in addition to purchasing because such activity does not, by itself, give rise to a permanent establishment under Article 5 (Permanent Establishment) to which income can be attributed. When it applies, the rule provides that business profits may be attributable to a permanent establishment with respect to its non-purchasing activities (*e.g.*, sales activities), but not with respect to its purchasing activities. The Technical Explanation states that the rule was not included in the proposed treaty because such a result is inconsistent with the arm's-length principle, which would view a separate and distinct enterprise as receiving some compensation to perform purchasing services.

The proposed treaty requires the determination of business profits of a permanent establishment to be made in accordance with the same method year by year unless a good and sufficient reason to the contrary exists.

The proposed treaty generally waives the application of the U.S. insurance excise tax on premiums on policies issued by foreign insurers and reinsurers, in the case of a U.K. enterprise carrying on an insurance business.

The waiver of the insurance excise tax generally does not apply, however, if the policies are entered into as part of a conduit arrangement. A conduit arrangement is defined in paragraph (1)(n) of Article 3 of the proposed treaty as a transaction (or series of transactions) in which a resident of the United States or the United Kingdom (that is entitled to the benefits of the proposed treaty) receives income arising in the other country, then pays it to a resident of a third country who is not entitled to equivalent or more favorable treaty benefits. The arrangement is treated as a conduit arrangement only if has as its main purpose, or one of its main purposes, obtaining the increased benefits available under the proposed treaty.

The Technical Explanation notes that U.S. domestic law provides specific anti-conduit rules as well as domestic anti-abuse principles, and states that the United States intends to interpret the conduit arrangement provisions of the proposed treaty in accordance with U.S. domestic law, as it may evolve over time. The Technical Explanation further states that the United States will interpret the provision of the proposed treaty by analogy to the anti-conduit rules of Treas. Reg. sec. 1.881-3. The Technical Explanation notes that the application of the anti-conduit rules to the insurance excise tax is somewhat narrower than the exception in other U.S. tax treaties that cover the insurance excise tax, because it includes the intent test found in the anti-conduit test applicable to withholding taxes.

The U.S. insurance excise tax does not apply to amounts that are effectively connected to a U.S. trade or business, including income from a U.S. permanent establishment. The proposed treaty pro-

vides for the same result as U.S. domestic law, by providing that the anti-conduit exception to the waiver of the insurance excise tax does not apply in the case of premiums attributable to a U.K. enterprise's permanent establishment in the United States. Thus, the provision of U.S. domestic law would prevent the application of the insurance excise tax in this situation, although the U.S. income tax would apply under U.S. domestic law. As discussed above, another provision of Article 7 provides that the business profits of a U.K. enterprise that are attributable to a permanent establishment in the United States may be taxed in the United States.

Where business profits include items of income that are dealt with separately in other articles of the proposed treaty, those other articles, and not the business profits article, govern the treatment of those items of income. Thus, for example, dividends are taxed under the provisions of Article 10 (Dividends), and not as business profits, except as specifically provided in Article 10.

The proposed treaty provides that, for purposes of the taxation of business profits, income may be attributable to a permanent establishment (and therefore may be taxable in the source country) even if the payment of such income is deferred until after the permanent establishment or fixed base has ceased to exist. This rule incorporates into the proposed treaty the rule of Code section 864(c)(6) described above. This rule applies with respect to business profits (Article 7, paragraphs 1 and 2), dividends (Article 10, paragraph 5), interest (Article 11, paragraph 3), royalties (Article 12, paragraph 3), and other income (Article 22, paragraph 2). A similar rule is included in paragraph 3 of Article 13 (Gains).

The Technical Explanation notes that this article is subject to the savings clause of paragraph 4 of Article 1 (General Scope), as well as Article 23 (Limitation on Benefits). Thus, in the case of the savings clause, if a U.S. citizen who is a resident of the United Kingdom derives business profits from the United States that are not attributable to a permanent establishment in the United States, the United States may, subject to the special foreign tax credit rules of paragraph 6 of Article 24 (Relief from Double Taxation), tax those profits, notwithstanding that paragraph 1 of this Article would exempt the income from U.S. Tax.

Article 8. Shipping and Air Transport

Article 8 of the proposed treaty covers income from the operation of ships and aircraft in international traffic. The rules governing income from the disposition of ships, aircraft, and containers are in Article 13 (Capital Gains).

The United States generally taxes the U.S.-source income of a foreign person from the operation of ships or aircraft to or from the United States. An exemption from U.S. tax is provided if the income is earned by a corporation that is organized in, or an alien individual who is resident in, a foreign country that grants an equivalent exemption to U.S. corporations and residents. The United States has entered into agreements with a number of countries providing such reciprocal exemptions.

Like the present treaty, the proposed treaty provides that profits that are derived by an enterprise of one country from the operation in international traffic of ships or aircraft are taxable only in that

country, regardless of the existence of a permanent establishment in the other country. “International traffic” is defined in Article 3(1)(f) (General Definitions) as any transport by a ship or aircraft, except when the transport is solely between places in the other treaty country.

The proposed treaty provides that profits from the operation of ships or aircraft in international traffic include profits derived from the rental of ships or aircraft on a full (time or voyage) basis (*i.e.*, with crew). Like the present treaty, it also includes profits from the rental of ships or aircraft on a bareboat basis (*i.e.*, without crew) if such rental activities are incidental to the activities from the operation of ships or aircraft in international traffic. The Technical Explanation notes that this provision is narrower than the U.S. Model, which also covers rentals from bareboat leasing that are not incidental to the operation of ships and aircraft in international traffic by the lessor. Under the proposed treaty, income from such rentals is covered by Article 7 (Business Profits).

The proposed treaty provides that profits derived by an enterprise from the inland transport of property or passengers within either treaty country are treated as profits from the operation of ships or aircraft in international traffic (and, thus, governed by this Article) if such transport is undertaken as part of international traffic by the enterprise. For example, if a U.K. enterprise contracts to carry property from the United States to the United Kingdom and, as part of the contract, it transports (or contracts to transport) the property by truck from its point of origin to an airport in the United States, the income earned by the U.K. enterprise from the overland leg of the journey would be taxable only in the United Kingdom. Similarly, the diplomatic notes state that this Article would also apply to income from lighterage undertaken as part of the international transport of goods.

The proposed treaty provides that profits of an enterprise of a country from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) used for the transport of goods or merchandise in international traffic is taxable only in that country. The Technical Explanation states that, unlike the OECD Model, this rule applies without regard to whether the recipient of the income is engaged in the operation of ships or aircraft in international traffic or whether the enterprise has a permanent establishment in the other country.

As under the U.S. model, the shipping and air transport provisions of the proposed treaty apply to profits derived 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.

The Technical Explanation notes that this article is subject to the savings clause of paragraph 4 of Article 1 (General Scope), as well as Article 23 (Limitation on Benefits).

Article 9. Associated Enterprises

The proposed treaty, like most other U.S. tax treaties, contains an arm’s-length pricing provision. The proposed treaty recognizes the right of each country to make an allocation of profits to an en-

enterprise of that country in the case of transactions between related enterprises, if conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises. In such a case, a country may allocate to such an enterprise the profits which it would have accrued but for the conditions so imposed. This treatment is consistent with the U.S. model.

For purposes of the proposed treaty, an enterprise of one country is related to an enterprise of the other country if one of the enterprises participates directly or indirectly in the management, control, or capital of the other enterprise. Enterprises are also related if the same persons participate directly or indirectly in their management, control, or capital.

Under the proposed treaty, when a redetermination of tax liability has been made by one country under the provisions of this article, the other country will make an appropriate adjustment to the amount of tax paid in that country on the redetermined income. In making such adjustment, due regard is to be given to other provisions of the proposed treaty and proposed protocol. Any such adjustment is to be made only in accordance with the mutual agreement procedures of the proposed treaty. The proposed treaty's saving clause retaining full taxing jurisdiction in the country of residence or citizenship does not apply in the case of such adjustments. Accordingly, internal statute of limitations provisions do not prevent the allowance of appropriate correlative adjustments. However, the Technical Explanation states that statutory or procedural limitations cannot be overridden to impose additional tax because paragraph 2 of Article 1 (General Scope) provides that the proposed treaty cannot restrict any statutory benefit.

The diplomatic notes state that, if the amount of interest or royalties paid exceeds the amount that would have been paid in the absence of a special relationship under paragraph 4 of Article 11 (Interest) or paragraph 4 of Article 12 (Royalties), a treaty country generally will adjust the amount of deductible interest or royalties paid under the authority of this Article and make any other appropriate adjustments. The diplomatic notes further state that the treaty country making the adjustments will not also impose its domestic rate of withholding tax with respect to such excess amount.

The Technical Explanation also states that the proposed treaty does not limit any provisions of either country's internal law that permit the distribution, apportionment, or allocation of income, deductions, credits, or allowances between related parties, including adjustments in cases involving the evasion of taxes or fraud. Any such adjustments are permitted even if they are different from, or go beyond, those specifically authorized by this Article, as long as they are in accord with general arm's length principles.

Article 10. Dividends

Internal taxation rules

United States

The United States generally imposes a 30-percent tax on the gross amount of U.S.-source dividends paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not

apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In such a case, the foreign recipient is subject to U.S. tax on such dividends on a net basis at graduated rates in the same manner that a U.S. person would be taxed.

Under U.S. law, the term dividend generally means any distribution of property made by a corporation to its shareholders, either from accumulated earnings and profits or current earnings and profits. However, liquidating distributions generally are treated as payments in exchange for stock and, thus, are not subject to the 30-percent withholding tax described above (see discussion of capital gains in connection with Article 13 below).

Dividends paid by a U.S. corporation generally are U.S.-source income. Also treated as U.S.-source dividends for this purpose are portions of certain dividends paid by a foreign corporation that conducts a U.S. trade or business. The U.S. 30-percent withholding tax imposed on the U.S.-source portion of the dividends paid by a foreign corporation is referred to as the “second-level” withholding tax. This second-level withholding tax is imposed only if a treaty prevents application of the statutory branch profits tax.

In general, corporations are not entitled under U.S. law to a deduction for dividends paid. Thus, the withholding tax on dividends theoretically represents imposition of a second level of tax on corporate taxable income. Treaty reductions of this tax reflect the view that where the United States already imposes corporate-level tax on the earnings of a U.S. corporation, a 30-percent withholding rate may represent an excessive level of source-country taxation. Moreover, the reduced rate of tax often applied by treaty to dividends paid to direct investors reflects the view that the source-country tax on payments of profits to a substantial foreign corporate shareholder may properly be reduced further to avoid double corporate-level taxation and to facilitate international investment.

A real estate investment trust (“REIT”) is a corporation, trust, or association that is subject to the regular corporate income tax, but that receives a deduction for dividends paid to its shareholders if certain conditions are met. In order to qualify for the deduction for dividends paid, a REIT must distribute most of its income. Thus, a REIT is treated, in essence, as a conduit for federal income tax purposes. Because a REIT is taxable as a U.S. corporation, a distribution of its earnings is treated as a dividend rather than income of the same type as the underlying earnings. Such distributions are subject to the U.S. 30-percent withholding tax when paid to foreign owners.

A REIT is organized to allow persons to diversify ownership in primarily passive real estate investments. As such, the principal income of a REIT often is rentals from real estate holdings. Like dividends, U.S.-source rental income of foreign persons generally is subject to the 30-percent withholding tax (unless the recipient makes an election to have such rental income taxed in the United States on a net basis at the regular graduated rates). Unlike the withholding tax on dividends, however, the withholding tax on rental income generally is not reduced in U.S. income tax treaties.

U.S. internal law also generally treats a regulated investment company (“RIC”) as both a corporation and a conduit for income tax

purposes. The purpose of a RIC is to allow investors to hold a diversified portfolio of securities. Thus, the holder of stock in a RIC may be characterized as a portfolio investor in the stock held by the RIC, regardless of the proportion of the RIC's stock owned by the dividend recipient.

United Kingdom

The United Kingdom does not currently impose a withholding tax on dividend payments to nonresidents. The United Kingdom also currently does not impose a branch profits tax.

Proposed treaty limitations on internal law

In general

Under the proposed treaty, dividends paid by a company that is a resident of a treaty country to a resident of the other country may be taxed in such other country. Such dividends also may be taxed by the country in which the payor company is resident, but the rate of such tax is limited. Under the proposed treaty, source-country taxation of dividends (*i.e.*, taxation by the country in which the dividend-paying company is resident) generally is limited to 15 percent of the gross amount of the dividends paid to residents of the other treaty country. A lower rate of 5 percent applies if the beneficial owner of the dividend is a company that owns at least 10 percent of the voting stock of the dividend-paying company.

The term “beneficial owner” is not defined in the present treaty or proposed protocol and, thus, is defined under the internal law of the source country. The Technical Explanation states that the beneficial owner of a dividend for purposes of this article is the person to which the dividend income is attributable for tax purposes under the laws of the source country. Further, companies holding shares through fiscally transparent entities such as partnerships are considered to hold their proportionate interest in the shares.

In addition, the proposed protocol provides a zero rate of withholding tax with respect to certain intercompany dividends in cases in which there is a sufficiently high (80-percent) level of ownership (often referred to as “direct dividends”). The zero rate also would apply with respect to dividends received by a tax-exempt pension fund, provided that such dividends are not derived from the carrying on of a business, directly or indirectly, by such fund.

Zero rate for direct dividends

Under the proposed treaty, the withholding tax rate is reduced to zero on dividends beneficially owned by a company that has owned at least 80 percent of the voting power of the company paying the dividend for the 12-month period ending on the date the dividend is declared (subparagraph 3(a) of Article 10 (Dividends)).⁷ Under the present treaty, these dividends may be taxed at a 5-percent rate (although, as noted above, the United Kingdom currently does not exercise this right as a matter of domestic law, whereas the United States does).

⁷The Technical Explanation indicates that only direct ownership will count for this purpose. The text of the proposed treaty is less precise but is consistent with this view.

In certain circumstances, eligibility for the zero rate under the proposed treaty is subject to an additional restriction designed to prevent companies from reorganizing for the purpose of obtaining the benefits of the provision. Specifically, in cases in which a company satisfies the Limitation on Benefits article only under the “active trade or business” and/or “ownership/base-erosion” tests (paragraph 4 and subparagraph 2(f), respectively, of Article 23 (Limitation on Benefits)), the zero rate will apply only if the dividend-receiving company owned (directly or indirectly) at least 80 percent of the voting power of the dividend-paying company prior to October 1, 1998.⁸ In other cases, the Limitation on Benefits article itself is considered sufficient to prevent treaty shopping. Thus, companies that qualify for treaty benefits under the “public trading,” “derivative benefits,” or discretionary tests (subparagraph 2(c) and paragraphs 3 and 6, respectively, of Article 23 (Limitation on Benefits)) will not need to meet the October 1, 1998 holding requirement in order to claim the zero rate.

Prior to amendment by the proposed protocol, the language of the proposed treaty left open a fundamental interpretive issue regarding the scope of the zero-rate provision. Under the “derivative benefits” test of Article 23, a company may qualify for treaty benefits (including, potentially, the zero rate) if at least 95 percent of the vote and value of the company is owned (directly or indirectly) by seven or fewer “equivalent beneficiaries,” and less than 50 percent of its gross income for the year is paid or accrued in deductible form to persons who are not “equivalent beneficiaries” (paragraph 3 of Article 23 (Limitation on Benefits)). Under the proposed treaty as originally signed, one type of “equivalent beneficiary” was a company resident in a European Community member state that would have been entitled under a European Community Directive “to receive the particular class of income for which benefits are being claimed under [the proposed treaty] free of withholding tax” (subparagraph 7(d) of Article 23 (Limitation on Benefits), prior to amendment by the proposed protocol). Under the European Community “Parent-Subsidiary Directive,” dividends paid by a subsidiary resident in one member state to a parent company resident in another member state are exempt from withholding tax. Interpreting the originally proposed treaty language in light of the Parent-Subsidiary Directive, it could have been argued that any company resident in a European Community member state would have qualified as an “equivalent beneficiary” for purposes of the zero-rate provision, since it would have been entitled “to receive the particular class of income for which benefits are being claimed”—*i.e.*, a subsidiary-parent dividend, according to this view—free of withholding tax. If this view were correct, then the United States effectively would have agreed to extend the benefits of the zero-rate provision to European companies generally, rather than just to U.K. companies. The European companies simply would have had to place the stock of their U.S. subsidiaries into U.K. holding companies in order to enjoy the zero rate.

⁸ October 1, 1998 is the date on which the parties announced that they were negotiating the proposed treaty.

If, on the other hand, “the particular class of income” described in the “equivalent beneficiary” definition were construed as referring not to subsidiary-parent dividends generally, but rather to dividends from U.S. subsidiaries, then European companies would not have been eligible for the zero rate by way of the “derivative benefits” test and the Parent-Subsidiary Directive, since such companies would not have been entitled to receive dividends directly from U.S. subsidiaries free of withholding tax. This latter interpretation of the originally proposed treaty language is the one consistent with the intent of the United States. In negotiating the proposed treaty, the United States never intended to extend the benefits of the zero-rate provision to non-U.K. European parent companies as a class.

Since the language of the originally proposed treaty was ambiguous in this regard, and did arguably admit the former, unintended interpretation, the parties amended the proposed treaty’s “equivalent beneficiaries” definition in order to clarify that non-U.K. European parent companies will not be entitled to the benefits of the zero-rate provision through the expedient of establishing a U.K. holding company (paragraph 7(d) of Article 23 (Limitation on Benefits), as amended by article 4 of the proposed protocol). Under the amended definition, a non-U.K. European company can qualify as an equivalent beneficiary for purposes of the zero-rate provision only if such company: (1) would be entitled to all the benefits of a comprehensive income tax treaty between a European Community member state and the treaty country from which benefits under the proposed treaty are being claimed (*i.e.*, the United States); and (2) would be entitled to a zero rate of tax on the relevant dividends under such other treaty (*i.e.*, a treaty between another European Community member state and the United States). Thus, unless and until the United States adopts a zero-rate provision in a treaty with a given European Community member state, companies resident in such state will not be treated as equivalent beneficiaries for purposes of claiming the zero rate under the proposed treaty.⁹

Dividends paid by RICs and REITs

The proposed treaty generally denies the 5-percent and zero rates of withholding tax to dividends paid by “pooled investment vehicles” (*e.g.*, RICs and REITs).

The 15 percent rate of withholding is generally allowed for dividends paid by a RIC. The 15 percent rate of withholding is allowed for dividends paid by a REIT only if one of three additional conditions is met. First, the dividend may qualify for the 15 percent rate if the person beneficially entitled to the dividend is an individual holding an interest of not more than 10 percent in the REIT. Second, the dividend may qualify for the 15 percent rate if it is paid with respect to a class of stock that is publicly traded and the person beneficially entitled to 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 may qualify for the 15 percent rate if the person beneficially entitled to the dividend holds an interest in the

⁹See Part III, Article 23, *infra*, for a more detailed description of the “equivalent beneficiary” definition and the anti-treaty-shopping provision in general.

REIT of not more than 10 percent and the REIT is “diversified” (i.e., 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).

Dividends received by tax-exempt pension funds from RICs and REITs generally are eligible for the zero rate. In the case of REIT dividends, this eligibility is also subject to the requirement of meeting one of the three conditions described above in connection with the general 15-percent rate.

The Technical Explanation indicates that the restrictions on availability of the lower rates are intended to prevent the use of RICs and REITs to gain unjustifiable source-country benefits for certain shareholders resident in the United Kingdom. For example, a company resident in the United Kingdom could directly own a diversified portfolio of U.S. corporate shares and pay a U.S. withholding tax of 15 percent on dividends on those shares. There is a concern that such a company could purchase 10 percent or more of the interests in a RIC, which could even be established as a mere conduit, and thus obtain a lower withholding rate by holding a similar portfolio through the RIC (transforming portfolio dividends generally taxable at 15 percent into direct investment dividends taxable under the treaty at zero or 5 percent).

Similarly, the Technical Explanation gives an example of a resident of the United Kingdom directly holding real property and required to pay U.S. tax either at a 30 percent rate on gross income or at graduated rates on the net income. By placing the property in a REIT, the investor could transform real estate income into dividend income, taxable at the lower rates provided in the proposed treaty. The limitations on REIT dividend benefits are intended to protect against this result.

Special rules and limitations

The proposed treaty’s reduced rates of tax on dividends do not apply if the dividend recipient carries on business through a permanent establishment in the source country, or performs in the source country independent personal services from a fixed base located in that country, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such cases, the dividends effectively connected to the permanent establishment or the fixed base are taxed as business profits (Article 7).

The proposed treaty prevents the United States from imposing a tax on dividends paid by a U.K. company unless such dividends are paid to a resident of the United States or are attributable to a permanent establishment in the United States. Thus, this provision generally overrides the ability of the United States to impose a “second-level” withholding tax on the U.S.-source portion of dividends paid by a U.K. corporation. The proposed treaty also restricts the United States from imposing corporate level taxes on undistributed profits, other than a branch profits tax.

The United States is allowed under the proposed protocol to impose the branch profits tax (at a rate of 5 percent) on a U.K. corporation that either has a permanent establishment in the United States, or is subject to tax on a net basis in the United States on

income from real property or gains from the disposition of interests in real property. The tax is imposed on the “dividend equivalent amount,” as defined in the Code (generally, the dividend amount a U.S. branch office would have paid up to its parent for the year if it had been operated as a separate U.S. subsidiary). In cases in which a U.K. corporation conducts a trade or business in the United States but not through a permanent establishment, the proposed treaty completely eliminates the branch profits tax that the Code would otherwise impose on such corporation (unless the corporation earned income from real property as described above). The United Kingdom currently does not impose a branch profits tax. If the United Kingdom were to impose such tax, the base of such a tax would be limited to an amount analogous to the U.S. “dividend equivalent amount.”

The branch profits tax will not be imposed by the United States in cases in which a zero-rate would apply if the U.S. branch business had been conducted by the U.K. company through a separate U.S. subsidiary. In addition, the tax will not apply to a U.K. company that is considered a qualified person by reason of being a publicly-traded company, or that is entitled to benefits with respect to the dividend equivalent amount under the derivative benefits or competent-authority discretion rules under Article 23 (Limitation on Benefits).

The proposed treaty provides an anti-conduit provision under which the provisions with respect to dividends will not apply to any dividend paid under, or as part of, a conduit arrangement (as defined in Article 3 (General Definitions)).¹⁰

The proposed treaty generally defines “dividends” as income from shares (or other corporate participation rights that are not treated as debt under the law of the source country), as well as other amounts that are subjected to the same tax treatment as income from shares by the source country (e.g., constructive dividends).

Relation to other Articles

The technical explanation notes that the savings clause of paragraph 4 of Article 1 (General Scope) permits the United States to tax dividends received by its residents and citizens, subject to the special foreign tax credit rules of paragraph 6 of Article 24 (Relief from Double Taxation), as if the proposed treaty had not come into effect.

The benefits of the dividends article are also subject to the provisions of Article 23 (Limitation on Benefits). Thus, if a resident of the United Kingdom is the beneficial owner of dividends paid by a U.S. company, the shareholder must qualify for treaty benefits under at least one of the tests of Article 23 in order to receive the benefits of Article 10.

¹⁰See Part III, Article 3, *supra*, for a description of the proposed treaty’s conduit arrangement provisions, and Part IV.B, *infra*, for a discussion of the issues raised by these provisions.

Article 11. Interest

Internal taxation rules

United States

Subject to several exceptions (such as those for portfolio interest, bank deposit interest, and short-term original issue discount), the United States imposes a 30-percent withholding tax on U.S.-source interest paid to foreign persons under the same rules that apply to dividends. U.S.-source interest, for purposes of the 30-percent tax, generally is interest on the debt obligations of a U.S. person, other than a U.S. person that meets specified foreign business requirements. Also subject to the 30-percent tax is interest paid by the U.S. trade or business of a foreign corporation. A foreign corporation is subject to a branch-level excess interest tax with respect to certain “excess interest” of a U.S. trade or business of such corporation; under this rule, an amount equal to the excess of the interest deduction allowed with respect to the U.S. business over the interest paid by such business is treated as if paid by a U.S. corporation to a foreign parent and, therefore, is subject to the 30-percent withholding tax.

Portfolio interest generally is defined as any U.S.-source interest that is not effectively connected with the conduct of a trade or business if such interest (1) is paid on an obligation that satisfies certain registration requirements or specified exceptions thereto and (2) is not received by a 10-percent owner of the issuer of the obligation, taking into account shares owned by attribution. However, the portfolio interest exemption does not apply to certain contingent interest income.

If an investor holds an interest in a fixed pool of real estate mortgages that is a real estate mortgage interest conduit (“REMIC”), the REMIC generally is treated for U.S. tax purposes as a pass-through entity and the investor is subject to U.S. tax on a portion of the REMIC’s income (which, generally is interest income). If the investor holds a so-called “residual interest” in the REMIC, the Code provides that a portion of the net income of the REMIC that is taxed in the hands of the investor—referred to as the investor’s “excess inclusion”—may not be offset by any net operating losses of the investor, must be treated as unrelated business income if the investor is an organization subject to the unrelated business income tax, and is not eligible for any reduction in the 30-percent rate of withholding tax (by treaty or otherwise) that would apply if the investor were otherwise eligible for such a rate reduction.

United Kingdom

U.K.-source interest payments to nonresidents generally are subject to withholding tax at a rate of 20 percent. However, tax is generally not required to be withheld on payments to nonresidents for interest from banks or building societies, interest on short-term loans (less than one year), or interest on government securities.

Proposed treaty limitations on internal law

The proposed treaty generally exempts interest arising in one country (the source country) and beneficially owned by a resident of the other country from tax in the source country. This exemption from source country tax is similar to that provided in the U.S. model and the present treaty. The present treaty generally exempts from U.S. tax interest derived and beneficially owned by a U.K. resident, and generally exempts from U.K. tax interest derived and beneficially owned by a U.S. resident.

The proposed treaty defines interest as income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits. In particular, it includes income from government securities and from bonds and debentures, including premiums or prizes attaching to such securities, bonds, or debentures. The term "interest" also includes all other income that is treated as income from money lent under the tax law of the country in which the income arises. Interest does not include income covered in Article 10 (Dividends). Penalty charges for late payment also are not treated as interest.

This exemption from source country tax does not apply if the beneficial owner of the interest carries on business through a permanent establishment in the source country and the interest paid is attributable to the permanent establishment. In that event, the interest is taxed as business profits (Article 7). According to the Technical Explanation, interest attributable to a permanent establishment but received after the permanent establishment is no longer in existence is taxable in the country where the permanent establishment existed.

The proposed treaty addresses the issue of non-arm's-length interest charges between related parties (or parties having an otherwise special relationship) by stating that this article applies only to the amount of arm's-length interest. Any amount of interest paid in excess of the arm's-length interest is taxable according to other provisions of the proposed treaty. For example, excess interest paid to a parent corporation may be treated as a dividend under local law and, thus, entitled to the benefits of Article 10 (Dividends). The Notes provide that if the amount of interest paid exceeds the amount that would have been paid in the absence of the special relationship, a country generally will adjust the amount of deductible interest paid under the authority of Article 9 (Associated Enterprises) and make such other adjustments as are appropriate. The Notes further provide that if adjustments are made, the country making such adjustment will not also impose its domestic withholding tax with respect to such excess amount.

The proposed treaty provides two anti-abuse exceptions to the general source-country exemption from tax discussed above. The first exception relates to "contingent interest" payments. If interest is paid by a source-country resident and is determined with reference to (1) receipts, sales, income, profits, or other cash flow of the debtor or a related person, (2) to any change in the value of any property of the debtor or a related person, or (3) to any dividend, partnership distribution, or similar payment made by the debtor to a related person, such interest may be taxed in the source country in accordance with its laws. However, if the beneficial

owner is a resident of the other country, such interest may not be taxed as a rate exceeding 15 percent (*i.e.*, the rate prescribed in paragraph 2(b) of Article 10 (Dividends)). The proposed treaty provides that this anti-abuse rule will not apply to any interest solely because it is paid under an arrangement providing that the amount of interest payable will be reduced (or increased) in the event of improvements (or deteriorations) in the factors by reference to which the amount of interest payable. The Technical Explanation states that interest will not, for example, become contingent interest solely by virtue of a provision in an agreement that calls for an increase in the rate charged upon the deterioration of the credit position of the borrower.

The second anti-abuse exception provides that exemptions from source country tax do not apply to interest paid with respect to ownership interests in a vehicle used for the securitization of real estate mortgages or other assets, to the extent that the amount of interest paid exceeds the return on comparable debt instruments as specified by the domestic law of that country. The Technical Explanation states that this provision denies source country exemptions with respect to excess inclusions with respect to a residual interest in a REMIC. This provision is analogous to the U.S. model, but is drafted reciprocally presumably to apply to similar U.K. securitization vehicles. Such income may be taxed in accordance with each country's internal law.

The proposed treaty provides an anti-conduit provision similar to that for dividends (Article 10) under which the provisions with respect to interest will not apply in respect of any interest paid under, or as part of, a conduit arrangement (as defined in Article 3 (General Definitions)).¹¹

Article 12. Royalties

Internal taxation rules

United States

Under the same system that applies to dividends and interest, the United States imposes a 30-percent withholding tax on U.S.-source royalties paid to foreign persons. U.S.-source royalties include royalties for the use of or right to use intangible property in the United States.

United Kingdom

Royalties paid to nonresidents are generally subject to a 22 percent withholding rate.

Proposed treaty limitations on internal law

The proposed treaty provides that royalties arising in a country (the source country) and beneficially owned by a resident of the other country is exempt from tax in the source country. This exemption from source country tax is similar to that provided in the U.S. model and the present treaty. The present treaty generally exempts from U.S. tax royalties derived and beneficially owned by a

¹¹See Part III, Article 3, *supra*, for a description of the proposed treaty's conduit arrangement provisions, and Part IV.B, *infra*, for a discussion of the issues raised by these provisions.

U.K. resident, and generally exempts from U.K. tax royalties derived and beneficially owned by a U.S. resident.

The term “royalties” means any consideration for the use of, or the right to use, any copyright of literary, artistic, scientific, or other work (including computer software and cinematographic films), including works reproduced on audio or video tapes or disks or any other means of image or sound production. The term also includes consideration for the use of, or the right to use, any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial, or scientific experience. The term also includes gain from the alienation of any right or property described in the preceding two sentences, to the extent that the amount of such gain is contingent on the productivity, use, or disposition of the right or property. The Technical Explanation states that the term royalties does not include income from leasing personal property. The Technical Explanation further states that it is understood that a typical retail sale of “shrink wrap” computer software will not be considered as royalty income (even though for copyright law purposes it may be characterized as a license).

The exemption from source country tax does not apply if the beneficial owner of the royalties carries on a business through a permanent establishment in the source country, and the royalties are attributable to the permanent establishment. In that event, the royalties are taxed as business profits (Article 7). According to the Technical Explanation, royalties attributable to a permanent establishment but received after the permanent establishment is no longer in existence is taxable in the country where the permanent establishment existed.

The proposed treaty addresses the issue of non-arm’s-length royalties between related parties (or parties otherwise having a special relationship) by providing that this article applies only to the amount of arm’s-length royalties. Any amount of royalties paid in excess of the arm’s-length interest is taxable according to other provisions of the proposed treaty. For example, excess royalties paid by a subsidiary corporation to its parent corporation may be treated as a dividend under local law and, thus, entitled to the benefits of Article 10 (Dividends). The Notes provide that if the amount of royalties paid exceeds the amount that would have been paid in the absence of the special relationship, a country generally will adjust the amount of deductible royalties paid under the authority of Article 9 (Associated Enterprises) and make such other adjustments as are appropriate. The Notes further provide that if adjustments are made, the country making such adjustment will not also impose its domestic withholding tax with respect to such excess amount.

As in the case of dividends (Article 10) and interest (Article 11), the proposed treaty includes an anti-conduit rule under which the provisions of this article will not apply in respect of any royalty paid under, or as part of, a conduit arrangement (as defined in Article 3 (General Definitions)).¹²

¹² See Part III, Article 3, *supra*, for a description of the proposed treaty’s conduit arrangement provisions, and Part IV.B, *infra*, for a discussion of the issues raised by these provisions.

Article 13. Gains

Internal taxation rules

United States

Generally, gain realized by a nonresident who is a noncitizen or a foreign corporation from the sale of a capital asset is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S. trade or business or, in the case of a nonresident who is a noncitizen, he or she is physically present in the United States for at least 183 days in the taxable year. A nonresident noncitizen or foreign corporation is subject to U.S. tax on gain from the sale of a U.S. real property interest as if the gain were effectively connected with a trade or business conducted in the United States. "U.S. real property interests" include interests in certain corporations if at least 50 percent of the assets of the corporation consist of U.S. real property.

United Kingdom

Capital gains are subject to tax at the normal corporate tax rate. Nonresidents carrying on a business in the United Kingdom through a U.K. branch or agency are charged tax on gains with respect to assets used in the branch or agency. Other nonresidents are generally not charged capital gains tax on the disposal of U.K. assets. A former resident who reestablishes residence in the United Kingdom within five years will remain subject to tax in the United Kingdom with respect to gains realized through the period of non-residence.

Proposed treaty limitations on internal law

The proposed treaty specifies rules governing when a country may tax gains from the alienation of property by a resident of the other country. The rules are generally consistent with those contained in the U.S. model. The present treaty generally provides that each country may tax capital gains in accordance with its own internal laws.

Under the proposed treaty, gains derived by a resident of one treaty country from the alienation of real property situated in the other country may be taxed in the country in which the property is situated. For the purposes of this article, real property situated in the other country includes rights to assets to be produced by the exploration or exploitation of the sea and sub soil of the other country and their natural resources, including rights to interests in or the benefit of such assets. In the case of the United States, the term includes a U.S. real property interest. In the case of the United Kingdom, the term includes (1) shares, including rights to acquire shares, (other than shares in which there is regular trading on a stock exchange) deriving their value or the greater part of their value directly or indirectly from real property situated in the United Kingdom, and (2) a partnership or trust interest to the extent that the assets of the partnership or trust consist of real property situated in the United Kingdom, or of shares referred to in (1) above.

The proposed treaty contains a standard provision which permits a country to tax gains from the alienation of property (other than real property) that forms a part of the business property of a permanent establishment located in that country. This rule also applies to gains from the alienation of such a permanent establishment (alone or with the enterprise as a whole). This rule also applies whether or not the permanent establishment exists at the time of alienation.

The proposed treaty provides that gains derived by an enterprise of one of the treaty countries from the alienation of ships or aircraft operated in international traffic by the enterprise are taxable only in such country. This rule also applies to gains derived from the sale of containers used in international traffic, or of property (other than real property) pertaining to the operation or use of such ships, aircraft, or containers.

Gains from the alienation of any property other than that discussed above is taxable under the proposed treaty only in the country where the person alienating the property is resident. The proposed treaty provides that this rule does not affect the right of a country to tax gains from the alienation of any property derived by an individual who is a resident of the other country and has been a resident of the first country at any time during the six years immediately preceding the alienation of the property. The Technical Explanation states that this special rule was included in the proposed treaty in order to allow the United Kingdom to apply its domestic law regarding such sales. According to the Technical Explanation, under U.K. law, a former U.K. resident who re-establishes U.K. residency within five years remains subject to U.K. tax on gains realized during the intermediate period of nonresidency.¹³ Under the proposed treaty, if such gains are derived while the individual was a U.S. resident and such gains are taxed by the United States in accordance with the proposed treaty and by the United Kingdom pursuant to this provision, then such gains will be treated as U.S.-source income. Thus, pursuant to paragraph 2(b) of Article 24 (Relief from Double Taxation), discussed below, the United Kingdom will be required to grant a credit for U.S. taxes imposed on such gains.

Article 14. Income From Employment

Under the proposed treaty, salaries, wages, and other similar remuneration derived from services performed as an employee in one treaty country (the source country) by a resident of the other treaty country are taxable only by the country of residence if three requirements are met: (1) the individual is present in the source country for not more than 183 days in any twelve-month period commencing or ending in the taxable year or year of assessment concerned; (2) the individual is paid by, or on behalf of, an employer who is not a resident of the source country; and (3) the remuneration is not borne by a permanent establishment of the employer in the source country. These limitations on source country

¹³The Technical Explanation further states that the analogous U.S. rules under Code section 877 (dealing with the taxation of certain U.S.-source income of former U.S. citizens and long-term residents) is separately preserved in the treaty under paragraph 6 of Article 1 (General Scope).

taxation are similar to the rules of the U.S. model and OECD model.

The proposed treaty contains a special rule that permits remuneration derived by a resident of one treaty country with respect to employment as a regular member of the crew of a ship or aircraft operated in international traffic by an enterprise of the other treaty country to be taxed only in the first treaty country. A similar rule is included in the OECD model. U.S. internal law does not impose tax on such income of a person who is neither a citizen nor a resident of the United States, even if the person is employed by a U.S. entity.

The diplomatic notes provide special rules concerning the treatment of employee share or stock option plans under this article. The diplomatic notes state that any benefits, income or gains received by employees under such plans constitute “other similar remuneration” and are subject to the application of this article. The notes require the allocation of taxing jurisdiction between the treaty countries over such plans if an employee: (1) has been granted a share or stock option in the course of employment in one of the treaty countries; (2) has exercised that employment in both treaty countries during the period between grant and exercise of the option; (3) remains in that employment on the date of the exercise; and (4) under the respective domestic laws of the treaty countries, would be taxable by both countries with respect to the gain on the option. Under this special allocation rule, each treaty country may tax, as the source country, only the portion of the gain on an option that relates to the period or periods between the grant and the exercise of the option during which the employee has exercised employment in that treaty country. The Technical Explanation states that the portion attributable to a treaty country under this rule will be determined by multiplying the gain by a fraction, the numerator of which is the number of days during which the employee exercised employment in that country and the denominator of which is the total number of days between the grant and the exercise of the option. To prevent the special allocation rule from resulting in double taxation, the diplomatic notes state that the competent authorities of the treaty countries will endeavor to resolve by mutual agreement any difficulties or doubts arising from the interpretation or application of this article and Article 24 (Relief from Double Taxation) in relation to employee share or stock option plans.

This article is subject to the provisions of the separate articles covering directors’ fees (Article 15), pensions, social security, annuities, alimony, and child support payments (Article 17), and government service income (Article 19).

Article 15. Directors’ Fees

Under the proposed treaty, director’s fees and other similar payments derived by a resident of one country for services rendered in the other country in his or her capacity as a member of the board of directors of a company that is a resident of that other country is taxable in that other country. Under the proposed treaty, as under the U.S. model, the country of the company’s residence may

tax the remuneration of nonresident directors, but only with respect to remuneration for services performed in that country.

Article 16. Entertainers and Sportsmen

Like the U.S. and OECD models, the proposed treaty contains a separate set of rules that apply to the taxation of income earned by entertainers (such as theater, motion picture, radio, or television artistes or musicians) and athletes. These rules apply notwithstanding the other provisions dealing with the taxation of income from personal services (Articles 7 and 14) and are intended, in part, to prevent entertainers and athletes from using the treaty to avoid paying any tax on their income earned in one of the countries.

Under the proposed treaty, income derived by an entertainer or athlete who is a resident of one country from his or her personal activities as such in the other country may be taxed in the other country if the amount of the gross receipts derived by him or her from such activities exceeds \$20,000 or its equivalent in pounds sterling. The \$20,000 threshold includes expenses that are reimbursed to the entertainer or athlete or borne on his or her behalf. Under this rule, if a U.K. entertainer or athlete maintains no fixed base in the United States and performs (as an independent contractor) in the United States for total compensation of \$10,000 during a taxable year, the United States would not tax that income. If, however, that entertainer's or athlete's total compensation were \$30,000, the full amount would be subject to U.S. tax.

The proposed treaty provides that where income in respect of activities performed by an entertainer or athlete in his or her capacity as such accrues not to the entertainer or athlete but to another person, that income is taxable by the country in which the activities are performed unless it is established that neither the entertainer or athlete nor persons related to him or her participated directly or indirectly in the profits of that other person in any manner, including the receipt of deferred remuneration, bonuses, fees, dividends, partnership distributions, or other distributions. This provision applies notwithstanding the business profits and income from employment articles (Articles 7 and 14). This provision prevents highly-paid entertainers and athletes from avoiding tax in the country in which they perform by, for example, routing the compensation for their services through a third entity such as a personal holding company or a trust located in a country that would not tax the income.

Article 17. Pensions, Social Security, Annuities, Alimony, and Child Support

This article deals with the taxation of private pensions and annuities, social security benefits, alimony and child support payments. This article does not cover government pensions.

Pensions

Under the proposed treaty, pensions and other similar remuneration derived and beneficially owned by a resident of either country is taxable only in the recipient's country of residence. The proposed treaty also requires each country not to tax the portion of pension

income received from pension schemes in the other country to the extent such income would have been exempt if the beneficiary were a resident of the other country.

The term “pension scheme” is defined in Article 3 (General Definitions). Unlike many U.S. income tax treaties and the U.S. model, the term “pensions and other similar remuneration” does not include lump sum payments.

The proposed treaty provides specific rules to deal with lump sum payments. Notwithstanding the general rule preventing source country taxation of pension schemes, any lump sum payment derived by a resident of one country from a pension scheme established in the other country is subject to tax in the other country. Thus, a U.S. person who receives a lump sum payment from a U.S. pension scheme (related to U.S. employment) would be subject to withholding tax if resident in the United Kingdom at the time of distribution. The Technical Explanation provides that the special rules related to lump sum payments are intended to address cases of double non-taxation that arise under the present treaty because the United Kingdom does not tax lump-sum distributions from pension funds.

Social Security benefits

The proposed treaty, like the present treaty, provides for exclusive residence-country taxation of social security benefits. This treatment differs from the U.S. model, which allows source country taxation of social security benefits. The provision under the proposed treaty applies to both private sector and government employees. The Technical Explanation provides that the term “similar legislation” is in reference to United States Tier 1 Railroad Retirement benefits.

Annuities

The proposed treaty also provides that annuities (other than those covered under the pension rule described above) derived and beneficially owned by a resident of either country are taxable only in the recipient’s country of residence. This is consistent with the corresponding rule in the U.S. model, which provides that annuities are taxable only in the individual recipient’s country of residence. The term “annuity” is defined for purposes of this provision as a stated sum paid periodically at stated time during the life of the annuitant, or during a specified or ascertainable period of time, under an obligation to make the payments in return for adequate and full consideration (other than in return for services rendered). The Technical Explanation states that an annuity received in consideration for services rendered would be treated as deferred compensation and generally taxable in accordance with Article 7 (Business Profits) or Article 14 (Income from Employment).

Alimony and Child Support

The proposed treaty allows residence country taxation of deductible alimony payments made by a resident of one country to a resident of the other country. The proposed treaty provides that child support payments are exempt from tax in both countries as long as such payments are not deductible to the payer. The treatment of

both child support and alimony payments is consistent with corresponding provisions under the U.S. model.

Article 18. Pension Schemes

This article deals with cross-border pension contributions. It is intended to remove barriers to the flow of personal services between the two countries that could otherwise result from discontinuities under the laws of each country regarding the deductibility of pension contributions.

The proposed treaty provides that neither country may tax residents on pension income earned through a pension scheme in the other country until such income is distributed. For purposes of this provision, roll-overs to other pension plans are not treated as distributions. When a resident receives a distribution from a pension plan, such distribution is generally subject to residency country taxation in accordance with Article 17 (Pensions, Social Security, Annuities, Alimony, and Child Support).

Under the proposed treaty, if an individual who is a member of a pension plan established and recognized under the law of one country performs personal services in the other country, contributions made by the individual to the plan during the period he or she performs such personal services are deductible in computing his or her taxable income in the other country within the limits that would apply if the contributions were made to a pension plan established and recognized under the laws of the other country. Similarly, payments made to the plan by or on behalf of his or her employer during such period are not treated as part of his or her taxable income and are allowed as a deduction in computing the employer's profits in the other country.

These rules apply only if: (1) contributions were made by or on behalf of the individual, or by or on behalf of the individual's employer to the plan (or to a similar plan for which this plan is substituted) before he or she began to exercise employment or self-employment in the other country; and (2) the competent authority of the other country has agreed that the plan generally corresponds to a pension plan recognized for tax purposes by that country. Moreover, the benefits provided under these rules will not exceed the benefits that would be allowed by the other country to its residents for contributions to a pension plan recognized for tax purposes by that country.

It is understood that for purposes of this provision, in accordance with the notes of the proposed treaty, U.S. pension schemes eligible for such benefits include qualified plans under section 401(a), individual retirement plans, individual retirement accounts, individual retirement annuities, section 408(p) accounts and Roth IRAs, section 403(a) qualified annuity plans, and section 403(b) plans.

The proposed treaty further provides that where contributions to a foreign pension plan are deductible in computing an individual's taxable income in a country and the individual is subject to tax in that country only in respect of income or gains remitted or received in such country, then the deduction otherwise allowed for such contributions is reduced to an amount that bears the same proportion to such deduction as the amount remitted bears to the full amount of the individual's income or gains that would be taxable in the

country if the individual had not been subject to tax on remitted amounts only. This rule is necessary because of the United Kingdom's remittance system of taxation for individuals who are U.K. residents not domiciled in the United Kingdom.

The proposed treaty also provides a U.S. citizen resident in the United Kingdom may exclude or deduct for U.S. tax purposes certain contributions to a pension scheme established in the United Kingdom that would not have been taxable in the United States in computing the employee's taxable income, provided such contributions are made during the period the U.S. citizen exercises employment in the United Kingdom and expenses related to such employment are borne by a U.K. employer or U.K. permanent establishment. Similarly, employer contributions to and benefits accrued in the U.K. pension scheme are not treated as taxable income in the United States.

Article 19. Government Service

Under the proposed treaty, remuneration, other than a pension, paid by a treaty country (or a political subdivision or local authority thereof) to an individual for services rendered to that country (or subdivision or authority) generally is taxable only by that country. However, such remuneration is taxable only by the other country if the services are rendered in that other country by an individual who is a resident of that country and who: (1) is also a national of that country; or (2) did not become a resident of that country solely for the purpose of rendering the services. This treatment is similar to the OECD model, but differs from the U.S. model in that these rules only apply to government employees and not to independent contractors engaged by governments to perform services for them.

The proposed treaty provides that any pension paid by a treaty country (or a political subdivision or local authority thereof) to an individual for services rendered to that country (or subdivision or authority) generally is taxable only by that country. However, such a pension is taxable only by the other country if the individual is a national and resident of that other country. Social security benefits with respect to government service are subject to paragraph 2 of Article 17 (Pensions, Social Security, Annuities, Alimony, and Child Support) and not this article.

The provisions of this article are exceptions to the proposed treaty's savings clause for individuals who are neither citizens nor permanent residents of the country where the services are performed. Thus, for example, payments by the government of the United Kingdom to its employees in the United States are exempt from U.S. tax if the employees are not U.S. citizens or green card holders and were not residents of the United States at the time they became employed by the United Kingdom government.

The proposed treaty provides that if a treaty country (or a political subdivision or local authority thereof) is carrying on a business (as opposed to functions of a governmental nature), the provisions of Articles 14 (Income from Employment), 15 (Directors' Fees), 16 (Entertainers and Sportsmen), and 17 (Pensions, Social Security, Annuities, Alimony, and Child Support) will apply to remuneration

and pensions for services rendered in connection with that business.

Article 20. Students

The treatment provided to students and business apprentices under the proposed treaty generally corresponds to the treatment provided under the present treaty, with certain modifications. The provision in the proposed treaty corresponds to the provision in the U.S. model.

Under the proposed treaty, a student or business apprentice who visits a country (the host country) for the purpose of his or her full-time education at a university, college, or other recognized educational institution of a similar nature, or for his or her full-time training, and who immediately before that visit is, or was a resident of the other treaty country, generally is exempt from host country tax on payments he or she receives for the purpose of such maintenance, education, or training; provided, however, that such payments arise outside the host country. The Technical Explanation states that for purposes of this article, the phrase “university, college, or other recognized educational institution of a similar nature” clarifies that a qualifying education institution is one that offers a diversified curriculum for full-time students. Whether a student is to be considered full-time will be determined by the rules of the educational institution where he or she is studying. The Technical Explanation also states that an educational institution is understood to be an institution that normally maintains a regular faculty and normally has a regular body of students in attendance at the place where the education activities are carried on. An educational institution is considered to be recognized if it is accredited by an authority that generally is responsible for the accreditation of institutions in the particular field of study. The Technical Explanation states that a payment generally is considered to arise outside the host country if the payer is located outside the host country.

Under the proposed treaty, the exemption from host country tax will apply to a business apprentice only for a period of not more than one year from the date he or she first arrives in the host country for the purpose of training. This limitation is not contained in the present treaty.

This article of the proposed treaty is an exception from the saving clause in the case of persons who are neither citizens nor lawful permanent residents of the host country.

Article 20A. Teachers

The treatment provided to professors and teachers under the proposed treaty corresponds to the treatment provided under the present treaty, with certain modifications. Such a provision is not part of the U.S. model. Such a provision is not part of the OECD model. Prior to amendment by the proposed protocol, the proposed treaty would have conformed to the U.S. model and OECD model.

Under the proposed treaty, a professor or teacher who visits a country (the host country) for the purpose of teaching or engaging in research at a university, college, or other recognized educational institution of a similar nature, and who immediately before that

visit is, or was a resident of the other treaty country, generally is exempt from host country tax on any remuneration received for teaching or research. This exemption applies for not more than the two-year period beginning on the date of the professor's or teacher's arrival in the host country. If the professor or teacher remains in the host country for more than two years, the exemption does not apply for the first two years.

This article of the proposed treaty is an exception from the saving clause in the case of persons who are neither citizens nor lawful permanent residents of the host country.

Article 21. Offshore Exploration and Exploitation Activities

The treatment provided under the proposed treaty for offshore exploration and exploitation activities is similar to that provided under the present treaty, with certain modifications. The U.S. and OECD models address the taxation of these activities under the standard rules found in other articles (such as the Business Profits article).

Under the proposed treaty, an enterprise of a country which carries on exploration activities or exploitation activities in the other country will be deemed to be carrying on business in that other country through a permanent establishment situated therein. This provision applies notwithstanding any other provisions of the proposed treaty where activities are carried on offshore in a country in connection with exploration or exploitation of the sea bed and sub-soil and their natural resources situated in that country. This provision applies to all exploitation activities. It also applies to exploration activities carried on by an enterprise of a country (and certain associated persons) in the other country for a period or periods aggregating more than 30 days in any 12-month period. For this purpose, if an enterprise carrying on exploration activities in the other country is associated with another enterprise carrying on substantially similar activities there, the former enterprise will be deemed to carrying on all of the activities of the latter enterprise, except to the extent that those activities are carried on at the same time as its own activities. Enterprises are associated if one participates directly or indirectly in the management, control, or capital of the other, or if the same persons participate directly or indirectly in the management, control, or capital of both enterprises.

Under the proposed treaty, salaries, wages, and similar remuneration derived by a resident of one country from employment in respect of exploration activities or exploitation activities carried on in the other country, to the extent performed offshore in the other country, may be taxed in the other country. However, such remuneration is taxable only in the first country (i.e., the employee's country of residence) if the employment is performed in the other country for a period or periods not exceeding in the aggregate 30 days in any 12-month period.

Article 22. Other Income

This article is a catch-all provision intended to cover items of income not specifically covered in other articles, and to assign the right to tax income from third countries to either the United States or the United Kingdom. As a general rule, items of income not oth-

erwise dealt with in the proposed treaty (other than income paid out of trusts or the estates of deceased persons in the course of administration) which are beneficially owned by residents of one of the countries are taxable only in the country of residence. This rule is similar to the rules in the U.S. and OECD models.

This rule, for example, gives the United States the sole right under the proposed treaty to tax income derived from sources in a third country and paid to a U.S. resident. This article is subject to the saving clause, so U.S. citizens who are residents of the United Kingdom will continue to be taxable by the United States on their third-country income.

The general rule just stated does not apply to income (other than income from real property as defined in Article 6) if the beneficial owner of the income is a resident of one country and carries on business in the other country through a permanent establishment situated therein, and the income is attributable to such permanent establishment. In such a case, the provisions of Article 7 (Business Profits) will apply. Such exception also applies where the income is received after the permanent establishment or fixed base is no longer in existence, but the income is attributable to the former permanent establishment or fixed base.

The Technical Explanation states that under U.S. tax law, trust income and distributions have the character of the associated distributable net income and, thus, generally are covered under other articles of the proposed treaty. The notes confirm that income paid out of trusts or the estates of deceased persons in the course of administration is characterized for purposes of the proposed treaty according to the character of the underlying income.

The proposed treaty addresses the issue of non-arm's-length income amounts between related parties (or parties otherwise having a special relationship) by providing that the amount of income for purposes of applying this article is the amount that would have been agreed upon by the payer and the beneficial owner in the absence of the special relationship. Any amount of income paid in excess of such amount is taxable according to the laws of each country, taking into account the other provisions of the proposed treaty. This provision is not contained in the U.S. or OECD models (but is suggested in Commentary to the OECD model).

The proposed treaty provides that this article (Article 22) will not apply to any income paid under, or as part of, a conduit arrangement. This rule is similar to that provided with respect to the dividends, interest, and royalties articles (Articles 10, 11 and 12).¹⁴

Article 23. Limitation on Benefits

In general

The proposed treaty contains a provision generally intended to limit the indirect use of the proposed treaty by persons who are not entitled to its benefits by reason of residence in the United States or the United Kingdom, or in some cases, in another member country of the European Union ("EU") or the North American Free

¹⁴ See Part III, Article 3, *supra*, for a description of the proposed treaty's conduit arrangement provisions, and Part IV.B. *infra*, for a discussion of the issues raised by these provisions.

Trade Agreement (“NAFTA”). The current U.S.-U.K. income tax treaty does not include such a provision.

The proposed treaty is intended to limit double taxation caused by the interaction of the tax systems of the United States and the United Kingdom as they apply to residents of the two countries. At times, however, residents of third countries attempt to use a treaty. This use is known as “treaty shopping,” which refers to the situation where a person who is not a resident of either treaty country seeks certain benefits under the income tax treaty between the two countries. Under certain circumstances, and without appropriate safeguards, the third-country resident may be able to secure these benefits indirectly by establishing a corporation or other entity in one of the treaty countries, which entity, as a resident of that country, is entitled to the benefits of the treaty. Additionally, it may be possible for the third-country resident to reduce the income base of the treaty country resident by having the latter pay out interest, royalties, or other amounts under favorable conditions either through relaxed tax provisions in the distributing country or by passing the funds through other treaty countries until the funds can be repatriated under favorable terms.

The proposed anti-treaty shopping article provides that a treaty country resident is entitled to all treaty benefits only if it is in one of several specified categories. Generally, a resident of either country qualifies for the benefits accorded by the proposed treaty if such resident is within one of the following categories of “qualified persons” (and satisfies any other specified conditions for obtaining benefits):

- (1) An individual;
- (2) A qualified governmental entity;
- (3) A company that satisfies a public company test and certain subsidiaries of such companies;
- (4) An entity, other than a company, that satisfies a public ownership test and certain entities owned by such entities;
- (5) A tax-exempt pension scheme or employee benefit arrangement that meets an ownership test, or an organization operated exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes;
- (6) An entity that satisfies an ownership test and a base erosion test; and
- (7) A trust that satisfies an ownership test and a base erosion test.

Alternatively, a resident that does not fit into any of the above categories may claim treaty benefits with respect to certain items of income under a derivative benefits test. In addition, a resident that does not fit into any of the above categories may claim treaty benefits with respect to certain items of income under an active business test. Finally, a person that does not satisfy any of the above requirements may be entitled to the benefits of the proposed treaty if the source country’s competent authority so determines.

Individuals

Under the proposed treaty, individual residents of one of the countries are entitled to all treaty benefits.

Qualified governmental entities

Under the proposed treaty, a qualified governmental entity is entitled to all treaty benefits. Under Article 3 (General Definitions), qualified governmental entities include the two countries, their political subdivisions, or their local authorities. Qualified governmental entities also include certain government-owned corporations and other entities.

Public company tests

A company that is a resident of the United Kingdom or the United States is entitled to treaty benefits if the principal class of its shares is listed on a recognized U.S. or U.K. stock exchange and is regularly traded on one or more recognized stock exchanges. Thus, such a company is entitled to the benefits of the treaty regardless of where its actual owners reside.

In addition, a company that is a resident of the United Kingdom or the United States is entitled to treaty benefits if at least 50 percent of the aggregate vote and value of the company's shares is owned (directly or indirectly) by five or fewer companies that satisfy the test described above, provided that each intermediate owner used to satisfy the control requirement is a resident of the United Kingdom or the United States.

The term "recognized stock exchange" means the NASDAQ System owned by the National Association of Securities Dealers; any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934; the London Stock Exchange and any other recognized investment exchange within the meaning of the Financial Services Act of 1986 or the Financial Services and Markets Act of 2000; the Irish Stock Exchange; the Swiss Stock Exchange; the stock exchanges of Amsterdam, Brussels, Frankfurt, Hamburg, Johannesburg, Madrid, Milan, Paris, Stockholm, Sydney, Tokyo, Toronto, and Vienna; and any other stock exchange agreed upon by the competent authorities of the two countries.

The term "principal class of shares" means 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 single class of ordinary or common shares representing the majority of the aggregate voting power and value, then the "principal class of shares" means that class or any combination of classes of shares that represents, in the aggregate, a majority of the aggregate voting power and value of the company. For these purposes, the term "shares" includes depository receipts for shares or trust certificates for shares.

Shares are considered to be "regularly traded" in a taxable period on one or more recognized stock exchanges if the aggregate number of shares of that class traded during the 12 months ending on the day before the beginning of that taxable period is at least six percent of the average number of shares outstanding in that class during that 12-month period. The notes provide that if a class of shares was not listed on a recognized stock exchange during this 12-month period, the class of shares will be treated as regularly traded only if that class meets the aggregate trading requirements for the taxable period in which the income arises. The Technical

Explanation states that this requirement can be met by aggregating trading on one or more of the recognized stock exchanges.

Public entity tests

Under the proposed treaty, a person other than an individual or company that is a resident of the United Kingdom or the United States is entitled to treaty benefits if the principal class of units in that entity is listed or admitted to dealings on a recognized U.S. or U.K. stock exchange and is regularly traded on one or more recognized stock exchanges. Alternatively, the entity is entitled to treaty benefits if the direct or indirect owners of at least 50 percent of the beneficial interests in the entity are public entities under the preceding sentence or public companies described below.

The Technical Explanation states that this provision applies generally to trusts the shares of ownership in which are publicly traded and to trusts that are owned by publicly traded entities. The Technical Explanation further states that for U.S. tax purposes, this provision relating to publicly traded trusts is redundant because the United States generally would consider such entities to be companies covered by the public company tests described above.

The term “units” includes shares and any other instrument, not being a debt claim, granting an entitlement to share in the assets or income of, or to receive a distribution from, the entity. The term “principal class of units” means the class of units that represent the majority of the value of the entity. If no single class of units represent the majority of the value of the person, the “principal class of units” is any combination of classes that in the aggregate represent the majority of the value of the entity.

The term “regularly traded” is defined as above for public companies. The Technical Explanation states that trading on one or more recognized stock exchanges may be aggregated for purposes of this requirement.

Tax-exempt and charitable organizations

Under the proposed treaty, an entity is entitled to treaty benefits if it is a (1) pension scheme (defined in Article 3 (General Definitions) as a plan, scheme, fund, trust, or other arrangement that is operated principally to administer or provide pension or retirement benefits or to earn income for the benefit of such arrangements and that is generally exempt from income tax in that country), (2) a plan, scheme, fund, trust, company, or other arrangement established in a country that is operated exclusively to administer or provide employee benefits and that is generally exempt from income tax in that country, or (3) an organization that is established exclusively for religious, charitable, scientific, cultural, or educational purposes (notwithstanding that all or part of its income is tax-exempt); provided, however, that in the case of entities described in (1) or (2) above, more than 50 percent of the entity’s beneficiaries, members, or participants must be individual residents of either country.

Ownership and base erosion tests—entities

Under the proposed treaty, an entity that is a resident of one of the countries is entitled to treaty benefits if it satisfies an owner-

ship test and a base erosion test. Under the ownership test, on at least half the days of the taxable period, shares or other beneficial interests representing at least 50 percent of the entity's aggregate voting power and value must be owned (directly or indirectly) by certain qualified persons described above (*i.e.*, individuals, qualified governmental entities, companies that meet the public company test described above, entities that meet the public entity test described above, or entities that meet the tests described above for a tax-exempt pension scheme or employee benefit arrangement, or an organization operated exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes).

The base erosion test is satisfied only if less than 50 percent of the person's gross income for the taxable period is paid or accrued, directly or indirectly, in the form of deductible payments, to persons who are not residents of either treaty country. The notes provide that for this purpose, the term "gross income" means the total revenues derived by a resident of a country from its principal operations, less the direct costs of obtaining such revenues. The Technical Explanation states that in the case of the United States, the term "gross income" has the same meaning as under domestic law (*i.e.*, section 61 of the Code and the regulations thereunder). In addition, for purposes of this test, deductible payments do not include arm's-length payments in the ordinary course of business for services or tangible property and payments in respect of financial obligations to a bank; provided that, if the bank is not a resident of one of the countries, such payment is attributable to a permanent establishment of that bank located in one of the countries.

The Technical Explanation states that trusts may be entitled to the benefits of this provision if they are treated as residents of one of the countries and they otherwise satisfy the requirements of the provision. An additional way for trusts to qualify for treaty benefits is described below.

Ownership and base erosion tests—trusts

Under the proposed treaty, a trust or trustee of a trust (in their capacity as such) that is a resident of one of the countries is entitled to treaty benefits if it satisfies an ownership test and a base erosion test. Under the ownership test, at least 50 percent of the beneficial interests in the trust must be held by (1) individuals, qualified governmental entities, companies that meet the public company test described above, entities that meet the public entity test described above, or entities that meet the tests described above for a tax-exempt pension scheme or employee benefit arrangement, or an organization operated exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes, or (2) equivalent beneficiaries (as described below, in connection with the "derivative benefits" provision).

The base erosion test is satisfied only if less than 50 percent of the person's gross income arising to the trust or trustee (in their capacity as such) for the taxable period is paid or accrued, directly or indirectly, to persons who are not residents of either treaty country in the form of deductible payments for tax purposes in the trust or trustee's country of residence. The notes provide that for this purpose, the term "gross income" means the total revenues derived

by a resident of a country from its principal operations, less the direct costs of obtaining such revenues. The Technical Explanation states that in the case of the United States, the term “gross income” has the same meaning as under domestic law (*i.e.*, section 61 of the Code and the regulations thereunder). In addition, for purposes of this test, deductible payments do not include arm’s-length payments in the ordinary course of business for services or tangible property and payments in respect of financial obligations to a bank; provided that, if the bank is not a resident of one of the countries such payment is attributable to a permanent establishment of that bank located in one of the countries.

Derivative benefits rule

The proposed treaty contains a reciprocal derivative benefits rule. This rule effectively allows a U.K. company, for example, to receive “derivative benefits” in the sense that it derives its entitlement to U.S. tax reductions in part from the U.S. treaty benefits to which its owners would be entitled if they earned the income directly. If the requirements of this rule are satisfied, a company that is resident in one of the treaty countries will be entitled to the benefits of the proposed treaty.

A company resident in one of the countries satisfies this rule if both ownership and base-erosion requirements are met. Under the ownership requirement, shares representing at least 95 percent of the aggregate voting power and value of the company must be owned, directly or indirectly, by seven or fewer persons who are “equivalent beneficiaries.”

For this purpose, an equivalent beneficiary is a resident of a member state of the European Community or of a European Economic Area state or a party to the North American Free Trade Agreement, but only if one of two alternative conditions are satisfied. Under the first alternative condition, that resident must be entitled to all the benefits of a comprehensive tax treaty between its residence country and the country from which the benefits of the proposed treaty are being claimed. However, if such treaty does not contain a comprehensive limitation on benefits provision, the person must be a person that would be a qualified person under the tests described above (and in the case of trusts, without applying the ownership test for equivalent beneficiaries), if such person were a resident of the United Kingdom or the United States under the proposed treaty. With respect to dividends, interest, and royalties, the resident must be entitled under such treaty to a rate of tax that is at least as low as the rate applicable to such income under the proposed treaty. Under the second alternative condition for qualifying as an equivalent beneficiary, the person must be a resident of either the United States or the United Kingdom and be treated as a qualified person under the tests described above.¹⁵

Under the second requirement to satisfy the derivative benefits rule, the company must satisfy the base erosion test similar to that described above, with certain modifications. The base erosion test is satisfied only if less than 50 percent of the person’s gross income

¹⁵ See Part III, Article 10, *supra*, for a discussion of an interpretive issue that arose in connection with the zero-rate provision under the equivalent beneficiary definition in the proposed treaty as originally signed, prior to amendment by the proposed protocol.

for the taxable period is paid or accrued, directly or indirectly, to persons who are not equivalent beneficiaries (as defined above) in the form of deductible payments for tax purposes in the company's country of residence. The notes provide that for this purpose, the term "gross income" means the total revenues derived by a resident of a country from its principal operations, less the direct costs of obtaining such revenues. The Technical Explanation states that in the case of the United States, the term "gross income" has the same meaning as under domestic law (*i.e.*, section 61 of the Code and the regulations thereunder). In addition, for purposes of this test, deductible payments do not include arm's-length payments in the ordinary course of business for services or tangible property and payments in respect of financial obligations to a bank; provided that, if the bank is not a resident of one of the countries such payment is attributable to a permanent establishment of that bank located in one of the countries.

Active business test

Under the active business test, residents of one of the countries are entitled to treaty benefits with respect to income, profit, or gain derived from the other country if (1) the resident is engaged in the active conduct of a trade or business in its residence country, (2) the income is derived in connection with, or is incidental to, that trade or business, and (3) the trade or business is substantial in relation to the trade or business activity in the other country. The proposed treaty provides that the business of making or managing investments for the resident's own account does not constitute an active trade or business unless these activities are banking, insurance, or securities activities carried on by a bank, insurance company, or registered securities dealer. For this purpose, the proposed treaty defines the term "insurance company" as an incorporated or unincorporated entity if its gross income consists primarily of insurance or reinsurance premiums and investment income attributable to such premiums.

The notes provide that income is considered to be derived "in connection" with an active trade or business if the activity generating the item of income in the other country is a line of business that forms a part of, or is complementary to, the trade or business. The Technical Explanation states that a business activity generally is considered to form a part of a business activity conducted in the other country 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 notes clarify that the line of business in the country of residence may be, in relation to the activity in the country of source, upstream (*e.g.*, providing inputs to a manufacturing process that occurs in the other country), downstream (*e.g.*, selling the output of a manufacturer that is a resident of the other country), or parallel (*e.g.*, selling in one country the same sorts of products that are being sold by the trade or business carried on in the other country). The Technical Explanation further states that in order for two activities to be considered "complimentary," 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 of the other.

The notes provide that income is considered “incidental” to a trade or business if the item is not produced by a line of business that forms a part of, or is complimentary to, the trade or business, but the production of such item facilitates the conduct of the trade or business in the other country. The notes state that an example of such “incidental” income is interest income earned from the short-term investment of working capital of a resident of a country in securities issued by persons in the other country.

The proposed treaty provides that whether a trade or business is substantial is determined on the basis of all the facts and circumstances. The Technical Explanation states that this takes into account the comparative sizes of the trades or businesses in each country (measured by reference to asset values, income and payroll expenses), the nature of the activities performed in each country, and the relative contributions made to that trade or business in each country. The Technical Explanation further states that in making each determination or comparison, due regard will be given to the relative sizes of the U.S. and U.K. economies.

The proposed treaty provides that in determining whether a person is engaged in the active conduct of a trade or business, activities conducted by a partnership in which that person is a partner and activities conducted by persons connected to such person will be deemed to be conducted by such person. For this purpose, a person is connected to another person if (1) one person owns at least 50 percent of the beneficial interest in the other person (or, in the case of a company, owns shares representing at least 50 percent of the aggregate voting power and value of the company or the beneficial interest in the company), or (2) another person owns, directly or indirectly, at least 50 percent of the beneficial interest in each person (or, in the case of a company, owns shares representing at least 50 percent of the aggregate voting power and value of the company or the beneficial interest in the company). The proposed treaty provides that in any case, persons are considered to be connected if on the basis of all the facts and circumstances, one has control of the other or both are under the control of the same person or persons.

The term “trade or business” is not defined in the proposed treaty. However, as provided in Article 3 (General Definitions), undefined terms are to have the meaning which they have under the laws of the country applying the proposed treaty. In this regard, the Technical Explanation states that the U.S. competent authority will refer to the regulations issued under Code section 367(a) to define the term “trade or business.”

Disproportionate interests

The proposed treaty denies benefits to the disproportionate part of income earned by certain companies. Under the proposed treaty, a company that is a resident of one of the countries or a company that controls such a company has outstanding a class of shares: (1) that is subject to terms or other arrangements that entitle its holders to a portion of the income, profit, or gain of the company derived from the other country that is larger than the portion such

holders would receive in the absence of such terms and arrangements, and (2) in which 50 percent or more of the voting power and value is owned by persons who are not equivalent beneficiaries (as defined above), then the benefits of the proposed treaty will apply only to that proportion of the income which those holders would have received in the absence of those terms or arrangements.

Grant of treaty benefits by the competent authority

The proposed treaty provides a “safety-valve” for a person that has not established that it meets one of the other more objective tests, but for which the allowance of treaty benefits would not give rise to abuse or otherwise be contrary to the purposes of the treaty. Under this provision, such a person may be granted treaty benefits if the competent authority of the source country determines that the establishment, acquisition, or maintenance of such resident and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the proposed treaty. The notes provide that in applying this provision, the competent authorities will consider the respective obligations of the United Kingdom by virtue of its membership in the European Community and by it being a party to the European Economic Area, and the respective obligations of the United States by virtue of it being a party to the North American Free Trade Agreement. The notes specify that in particular, the competent authorities will consider any legal requirements for the facilitation of the free movement of capital and persons, the differing internal tax systems, tax incentive regimes and existing treaty policies among member states of the European Community or the European Economic Area states, or parties to the North American Free Trade Agreement.

The notes further provide that where certain changes in circumstances might cause a person to cease to qualify as a qualified person (as defined above), such changes need not result in the denial of benefits under the treaty. The Technical Explanation states that this rule recognizes the legal requirements for the free flow of goods and services within the European Communities and within the North American Free Trade Agreement. The changes in circumstances contemplated by the notes include, all under ordinary business conditions,: (1) a change in the country of residence of a major participant in the company, (2) the sale of part of the ownership interests in a company to a resident of a qualifying country; (3) or an expansion of a company’s activities in another qualifying country. The notes provide that if the competent authority is satisfied that these changed circumstances are not attributable to tax avoidance motives, then this will be a factor weighing in favor of granting benefits in accordance with this provision.

The proposed treaty provides that the competent authority of the source country must consult with the competent authority of the residence country before refusing to grant benefits under this provision.

Article 24. Relief From Double Taxation

Internal taxation rules

United States

The United States taxes the worldwide income of its citizens and residents. It attempts unilaterally to mitigate double taxation generally by allowing taxpayers to credit the foreign income taxes that they pay against U.S. tax imposed on their foreign-source income. An indirect or “deemed-paid” credit is also provided. Under this rule, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and that receives a dividend from the foreign corporation (or an inclusion of the foreign corporation’s income) is deemed to have paid a portion of the foreign income taxes paid (or deemed paid) by the foreign corporation on its earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid for the year the dividend is received.

A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S.-source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit only offsets U.S. tax on foreign-source income. The foreign tax credit limitation generally is computed on a worldwide consolidated basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income. The limitation is computed separately for certain classifications of income (*e.g.*, passive income and financial services income) in order to prevent the crediting of foreign taxes on certain high-taxed foreign-source income against the U.S. tax on certain types of traditionally low-taxed foreign-source income. Other limitations may apply in determining the amount of foreign taxes that may be credited against the U.S. tax liability of a U.S. taxpayer.

United Kingdom

U.K. double tax relief is allowed through a foreign tax credit. U.K. foreign tax credits are limited to the lesser of the foreign tax paid or the U.K. tax that relates to such amount of income. If the foreign tax credit is not claimed, a taxpayer may deduct from foreign gross income any foreign tax paid. Surplus foreign taxes may be carried forward indefinitely, or carried back for up to three years, to offset U.K. tax on income from the same source. U.K. law also provides for limited onshore pooling of dividend income.

Proposed treaty limitations on internal law

Overview

One of the principal purposes for entering into an income tax treaty is to limit double taxation of income earned by a resident of one of the countries that may be taxed by the other country. Unilateral efforts to limit double taxation are imperfect. Because of differences in rules as to when a person may be taxed on business income, a business may be taxed by two countries as if it were engaged in business in both countries. Also, a corporation or individual may be treated as a resident of more than one country and be taxed on a worldwide basis by both.

Part of the double tax problem is dealt with in other articles of the proposed treaty that limit the right of a source country to tax income. This article provides further relief where both the United Kingdom and the United States otherwise still tax the same item of income. This article is not subject to the saving clause, so that the country of citizenship or residence will waive its overriding taxing jurisdiction to the extent that this article applies.

The present treaty provides separate rules for relief from double taxation for the United States and the United Kingdom. The present treaty generally provides for relief from double taxation of U.S. residents and citizens by requiring the United States to permit a credit against its tax for taxes paid to the United Kingdom. The determination of this credit is made in accordance with U.S. law. The present treaty treats the U.K. petroleum revenue tax as a creditable tax, subject to certain limitations provided in the treaty. In the case of the United Kingdom, the present treaty generally provides relief from double taxation by requiring the United Kingdom to permit a credit against its tax for taxes paid to the United States, subject to U.K. law provisions allowing a foreign tax credit.

Treaty restrictions on U.S. internal law

The proposed treaty generally provides that the United States will allow a U.S. citizen or resident a foreign tax credit for the income taxes imposed by the United Kingdom. The proposed treaty also requires the United States to allow a deemed-paid credit, with respect to U.K. income tax, to any U.S. company that receives dividends from a U.K. company if the U.S. company owns 10 percent or more of the voting stock of such U.K. company. The credit generally is to be computed in accordance with the provisions and subject to the limitations of U.S. law (as such law may be amended from time to time without changing the general principles of the proposed treaty provisions). This provision is similar to those found in the U.S. model and many U.S. treaties.

The proposed treaty provides that the taxes referred to in paragraphs 3(b) and 4 of Article 2 (Taxes Covered) will be considered creditable income taxes for purposes of the proposed treaty. This includes the U.K. income tax, capital gains tax, corporation tax, and the petroleum revenue tax (subject to the provisions and limitations of Article 23 (Relief from Double Taxation)).

The proposed treaty contains a resourcing rule for these purposes. Under the proposed treaty, an item of gross income (as defined under U.S. law) that is derived by a U.S. resident and that is taxed by the United Kingdom under the proposed treaty will be deemed to be U.K.-source income for U.S. foreign tax credit purposes. The Technical Explanation states that this resourcing rule is intended to ensure that a U.S. resident can obtain a U.S. foreign tax credit for U.K. taxes paid when the proposed treaty assigns primary taxing jurisdiction to the United Kingdom. The Technical Explanation further states that in the case of a U.S.-owned foreign corporation, the resourcing rules under Code section 904(g)(10) may apply for purposes of determining the amount of the U.S. foreign tax credit with respect to such income (including rules applying separate foreign tax credit limitations to such resourced income). The U.S. model does not contain a resourcing rule. However, a

similar resourcing rule is contained in the present treaty. According to the notes, if a U.S. resident receives a dividend from a U.K. company that is eligible for the deemed-paid credit, such dividend will be deemed to constitute U.K.-source income, even if the dividend may be taxed only in the United States because the zero rate of withholding applies (pursuant to paragraph 3(a) of Article 10 (Dividends)).

The general resourcing rule described above does not apply in the case of certain gains. Under the proposed treaty, gains derived by an individual while he or she was a U.S. resident and that are taxed by the United States under the proposed treaty, but that also may be taxed by the United Kingdom under paragraph 6 of Article 13 (Gains), will be deemed to be U.S.-source gain. Paragraph 6 of Article 13 (Gains) provides that each country may tax gains derived by certain non-residents who used to be residents of that country, and it allows the United Kingdom to tax gains from the alienation of property derived by a individual who is a U.S. resident and who had been a U.K. resident during the six years immediately preceding the alienation. Thus, for example, if a U.K. resident gives up his or her U.K. resident and becomes a U.S. resident, sells property, and then re-establishes residence in the United Kingdom within five years, such gains are considered to be U.S.-source income.

The proposed treaty provides special rules and limits to determine the amount of creditable U.K. petroleum revenue taxes. The credit is limited to the amount attributable to U.K.-source taxable income. The proposed treaty provides further limitations on crediting such taxes that are similar to the present treaty, with certain modifications. Under the proposed treaty, the amount of U.K. petroleum revenue tax on income from the extraction of minerals from oil or gas wells in the United Kingdom to be allowed as a credit may not exceed the amount, if any, by which the product of the maximum U.S. statutory rate applicable to a corporation (currently 35 percent) for such taxable year and the amount of such income exceeds the amount of other U.K. tax on such income. The Technical Explanation states that the limitations provided under the proposed treaty apply before applying other foreign tax credit limitations contained under the Code (e.g., section 907 of the Code relating to foreign oil and gas extraction income and foreign oil related income).

The Technical Explanation describes a four-step process for computing the creditable U.K. petroleum revenue taxes. Under the first step, the amount of the corporation's taxable income (computed under U.S. standards) from the extraction of oil or gas wells in the U.K. is multiplied by 35 percent (the maximum U.S. statutory corporate rate). Under the second step, the amount of other U.K. tax imposed on the taxpayer's income from the extraction of minerals from oil or gas wells in the United Kingdom is subtracted from the product arrived at under the first step. The Technical Explanation states that because other U.K. taxes on such income may be calculated on a base which includes non-extraction activities, it may be necessary to allocate other U.K. tax to the extraction income, and that principles similar to Code section 907(c)(5) are to apply for this purpose. The difference between the amounts computed

under these first two steps is the limitation with respect to the petroleum revenue tax on extraction income.

Under the third step, the total U.K. petroleum revenue tax paid or accrued must be allocated to income from extraction and to income from initial transportation, initial treatment, and initial storage. The Technical Explanation states that under the U.K. Oil Taxation Act of 1975, as amended March 15, 1979, which is the legislation that imposes the U.K. petroleum revenue tax, it is possible for the tax to be levied on income from non-extraction activities. Specifically, the base on which the petroleum revenue tax is computed is determined by reference to the value of oil or gas after initial transportation to the U.K., and after initial treatment and initial storage. The Technical Explanation states that the U.K. petroleum revenue tax allocated to income from extraction is determined by multiplying the total petroleum revenue tax by a fraction, the numerator of which is taxable income from extraction determined under U.S. standards (i.e., the amount determined under the first step) and the denominator of which is taxable income from extraction, initial transportation, initial treatment, and initial storage.

Under the fourth step, the lesser of the petroleum revenue tax paid or accrued with respect to extraction income under the third step or the limit determined under the second step is treated as income taxes paid or accrued for the taxable year under section 901 of the code.

The proposed treaty provides for a carryback or carryforward of the amount of petroleum revenue tax disallowed under the steps described above. Under the proposed treaty, where the amount of petroleum revenue tax allocable to extraction income (determined under the third step above) exceeds the credit limit (determined under the second step), the excess is treated as income taxes paid or accrued in the two preceding or five succeeding taxable years (in that order) and to the extent not deemed paid or accrued in a prior taxable year. The proposed treaty provides that such amounts are allowable as a credit in the year deemed paid or accrued subject to the limitations described above for claiming a credit for petroleum revenue taxes. The present treaty provides for a carryover of petroleum revenue taxes based on the lesser of the excess credit or 2 percent of extraction income for the taxable year. The Technical Explanation states that the proposed treaty does not contain this additional restriction on the carryover of credits to account for the intervening repeal of the 2-percent ceiling.

The proposed treaty applies similar limitations and carryover provisions for U.K. petroleum revenue taxes with respect to income from initial transportation, initial treatment, and initial storage of minerals from oil or gas wells in the United Kingdom. Under the proposed treaty, these items of income are combined for this purpose and the amount of creditable taxes is computed by applying, *mutatis mutandis*, the first, second, and fourth steps described above to such taxes. Credits disallowed are carried over in a similar manner to that discussed above.

The proposed treaty generally provides that the United Kingdom will allow its citizens and residents a credit against U.K. tax for U.S. taxes. For this purpose, the U.S. taxes referred to in paragraph 3(a)(i) and 4 of Article 2 (Taxes Covered) are considered U.S.

taxes. The credit is subject to the provisions of U.K. law regarding the allowance of credits against U.K. tax for taxes payable in a territory outside the United Kingdom (which may not affect the general principles of the proposed treaty provisions).

Under the proposed treaty, the amount of U.S. tax payable under U.S. laws and in accordance with the proposed treaty, whether directly or by deduction, on profits, income or chargeable gain from U.S. sources (excluding in the case of a dividend, U.S. tax in respect of the profits out of which the dividend is paid) is allowed as a credit against U.K. tax computed by reference to the same profits, income, or chargeable gains to which the U.S. tax is computed. In addition, in the case of a dividend paid by a U.S. company to a U.K. company which controls directly or indirectly at least 10 percent of the voting power of the payor company, the proposed treaty provides that the credit allowed must take into account (in addition to any U.S. tax allowed directly as described above) the U.S. tax payable by the company in respect of the profits out of which such dividend is paid.

The proposed treaty denies the U.K. credit described above with respect to dividends received by U.K. companies from U.S. companies in certain circumstances. Under the proposed treaty, the indirect credit may not be claimed if and to the extent that (1) the United Kingdom treats the dividend as beneficially owned by a U.K. resident, (2) the United States treats the same dividend as beneficially owned by a U.S. resident, and (3) the United States allows the U.S. resident a deduction in respect of the amount determined by reference to that dividend. The Technical Explanation states that this rule is intended to apply to a particular type of financing transaction that has been used widely by U.K. resident companies to finance their U.S. operations. The Technical Explanation provides an example of this transaction in which a U.S. holding company sells stock in another U.S. company to a U.K. company. Simultaneously, the U.S. holding company enters into a repurchase agreement with the U.K. company that allows the U.S. holding company to buy back the stock at a predetermined price. The sale and the repurchase agreement are structured in such a way that the transactions are treated together as a loan for U.S. tax purposes (with the dividends paid to the U.K. company treated as payments of interest on a loan from the U.K. company to the U.S. company). Because U.K. domestic law provides no mechanism for similarly treating the sale and repurchase in accordance with its economic substance, the United Kingdom would be required to respect the form of the transaction as a sale and grant an indirect credit with respect to dividends from the U.S. company, resulting in double non-taxation of income. However, U.K. domestic law does permit the United Kingdom to disallow U.K. foreign tax credits through its treaties.

The Technical Explanation states that the United Kingdom had seen several of these transactions and was concerned about the loss of U.K. tax revenues arising from the ability of a U.K. company to receive a U.K. foreign tax credit for a payment that economically is interest. Accordingly, the Technical Explanation states that the United Kingdom requested this exception to the general rule described above relating to U.K. foreign tax credits for dividends. In

order to facilitate the elimination of the U.K. foreign tax credit under this provision, the proposed treaty provides that paragraph 2 of Article 1 (General Scope) does not apply for this purpose, which otherwise would not permit the proposed treaty to restrict a benefit provided under (in this case) U.K. domestic law.

The proposed treaty provides a resourcing rule for purposes of allowing credits for U.S. taxes against U.K. taxes. The Technical Explanation states that this provision is intended to ensure that a U.K. resident can obtain a U.K. foreign tax credit for U.S. taxes paid when the proposed treaty assigns primary taxing jurisdiction to the United States. Under the proposed treaty, income of a U.K. resident that is taxed by the United States in accordance with the proposed treaty will be deemed to be U.S.-source income.

The proposed treaty contains special rules designed to provide relief from double taxation for U.S. citizens who are U.K. residents. Unlike the U.S. model, the rules also apply to former U.S. citizens or long-term residents who are U.K. residents. Under the proposed treaty, the United Kingdom is not required to provide a credit to such U.K. residents for U.S. tax on profits, income, or chargeable gains from sources outside the United States (as determined under U.K. laws). This provision is similar to a provision in the present treaty.

In addition, under the proposed treaty, the United Kingdom will allow a foreign tax credit to a U.S. citizen, former U.S. citizen, or former U.S. resident who is a U.K. resident by taking into account only the amount of U.S. taxes, if any, that may be imposed pursuant to the proposed treaty on a U.K. resident who is not a U.S. citizen. The Technical Explanation states that these rules apply to items of U.S.-source income that would either be exempt from U.S. tax or subject to reduced rates of U.S. tax under the proposed treaty if they had been received by a U.K. resident who is not a U.S. citizen. The Technical Explanation further states that the U.K. tax credit allowed with respect to such items need not exceed the U.S. tax that may be imposed under the proposed treaty, other than taxes imposed solely by reason of the U.S. citizenship of the taxpayer under saving clause of paragraph 4 of Article 1 (General Scope). The United States will then credit the income tax and capital gains tax actually paid to the United Kingdom, determined after application of the preceding rule. The proposed treaty recharacterizes the income that is subject to U.K. taxation as foreign-source income for purposes of this computation, but only to the extent necessary to avoid double taxation of such income.

The notes contain special rules for the application of Article 24 to fiscally transparent entities. The notes state that under paragraph 4 or 8 of Article 1 (General Scope), the proposed treaty may permit a country of which a person is resident (or, in the case of the United States, a citizen) to tax an item of income derived through another person (the "entity") that is fiscally transparent under the laws of either country, and may also permit the other country to tax the same person, the entity, or another person on that same item of income. The notes provide that in such circumstances, taxes paid or accrued by the entity will be treated as if it were paid or accrued by the first-mentioned person for purposes of determining relief from double taxation to be allowed by

that resident's home country (or, in the case of the United States, a citizen). Thus, according to the Technical Explanation, if a U.K. company pays interest to a U.K. unlimited liability company ("ULC") with U.S. resident partners and the ULC is treated for U.S. tax purposes as a partnership such that the partners are subject to U.S. tax on that income, but the United Kingdom taxes the ULC on such income as a U.K. resident, under the proposed treaty the United States will treat the U.K. tax paid by the ULC as having been paid by the partners for purposes of providing a foreign tax credit with respect to such interest income. The notes provide an exception from this rule for fiscally transparent entities in the case of items of income from real property to which paragraph 1 of Article 6 (Income from Real Property) applies, or gain from the alienation of real property to which paragraph 1 of Article 13 (Gains) applies. The notes provide that for such income and gains, the tax paid or accrued by the person who is a resident of the country in which the real property is situated will be treated as if it were paid by the person who is a resident of the other country.

The notes also provide special rules for the application of Article 24 where the same item of income, profit, or gain derived through a trust is treated by each country as derived by different persons resident in either country, and the person taxed by one country is the settlor or grantor of a trust, and the person taxed by the other country is a beneficiary of that trust. In such cases, the notes provide that the tax paid or accrued by the beneficiary will be treated as paid or accrued by the settlor or grantor for purposes of determining the relief from double taxation to be allowed by the country in which the settlor or grantor is resident (or, in the case of the United States, a citizen). Thus, according to the Technical Explanation, if a trust is a grantor trust for U.S. tax purposes and the income of the trust is included in the income of the grantor, but for U.K. tax purposes the beneficiaries must also pay tax on the same income, under the proposed treaty the United States would be required to provide a credit to the U.S. grantor for the U.K. tax imposed on the U.K. beneficiaries of the trust. The notes provide an exception from this rule in the case of items of income from real property to which paragraph 1 of Article 6 (Income from Real Property) applies, or gain from the alienation of real property to which paragraph 1 of Article 13 (Gains) applies. The notes provide that for such income and gains, the tax paid or accrued by the person who is a resident of the country in which the real property is situated will be treated as if it were paid by the person who is a resident of the other country.

The notes further provide that the resourcing rules in paragraphs 2 and 5 of this article (described above) will apply to such items of income through fiscally transparent entities to the extent necessary to provide relief from double taxation.

This article is not subject to the saving clause, so that the country of citizenship or residence will waive its overriding taxing jurisdiction to the extent that this article applies.

Article 25. Non-Discrimination

The proposed treaty contains a comprehensive non-discrimination article relating to all taxes of every kind imposed at the na-

tional, state, or local level. It is similar to the non-discrimination article in the U.S. model, the present treaty, and to provisions that have been included in other recent U.S. income tax treaties.

In general, under the proposed treaty, one country cannot discriminate by imposing more burdensome taxes (or requirements connected with taxes) on nationals of the other country than it would impose on its own nationals in the same circumstances, particularly with respect to taxation on worldwide income. The Technical Explanation states that if one person is taxable in a country on worldwide income and another is not, distinctions in such treatment would not be discriminatory. Like the U.S. model, non-discrimination protection is provided with respect to all taxes imposed by a country or its political subdivisions or local authorities, and not just to taxes covered by the proposed treaty under Article 2 (Taxes Covered). Unlike the U.S. model,¹⁶ the proposed treaty does not contain the provision extending the application of the non-discrimination rules to persons who are not residents of one or both of the States. The Technical Explanation states that this rule was not included in the proposed treaty at the request of the United Kingdom. Consistent with the U.K.'s position with respect to the proposed treaty, the United Kingdom has also stated that it reserves its position¹⁷ with respect to the parallel provision in the OECD model.¹⁸

Under the proposed treaty, neither country may tax a permanent establishment of an enterprise of the other country less favorably than it taxes its own enterprises carrying on the same activities. Similar to the U.S. and OECD models, however, a country is not obligated to grant residents of the other country any personal allowances, reliefs, or reductions for tax purposes that are granted to its own residents or nationals.

Each country is required (subject to the arm's-length pricing rules of paragraph 1 of Article 9 (Associated Enterprises), paragraph 4 of Article 11 (Interest), paragraph 4 of Article 12 (Royalties), or paragraph 3 of Article 22 (Other Income), and subject to the conduit arrangement rules of the second sentence of paragraph 5 of Article 7 (Business Profits), paragraph 9 of Article 10 (Dividends), paragraph 7 of Article 11 (Interest), paragraph 5 of Article 12 (Royalties), or paragraph 4 of Article 22 (Other Income)) to allow its residents to deduct interest, royalties, and other disbursements paid by them to residents of the other country under the same conditions that it allows deductions for such amounts paid to residents of the same country as the payor. The Technical Explanation states that 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. The Technical Explanation further states that the exception with respect to paragraph 4 of Article 11 (Interest) would include the denial or deferral of certain interest deductions under section 163(j) of the Code.

¹⁶ U.S. model, Article 24, paragraph 1, last sentence.

¹⁷ OECD model, Commentary on Article 24, paragraph 67.

¹⁸ OECD model, Article 24, paragraph 1, last sentence.

The non-discrimination rules also apply to enterprises of one country that are owned in whole or in part by residents of the other country. Enterprises resident in one country, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other country, will not be subjected in the first country to any taxation (or any connected requirement) that is more burdensome than the taxation (or connected requirements) that the first country imposes or may impose on its similar enterprises. The Technical Explanation includes examples of Code provisions that are understood by the two countries not to violate this provision of the proposed treaty. Those examples include the rules that impose a withholding tax on non-U.S. partners of a partnership and the rules that prevent foreign persons from owning stock in Subchapter S corporations.

The proposed treaty provides that nothing in the non-discrimination article is to be construed as preventing either of the countries from imposing a branch profits tax as described in paragraph 7 of Article 10 (Dividends). In addition, notwithstanding the definition of taxes covered in Article 2 (Taxes Covered), this article applies to taxes of every kind and description imposed by either country, or a political subdivision or local authority thereof.

The saving clause (which allows the country of residence or citizenship to impose tax notwithstanding certain treaty provisions) does not apply to the non-discrimination article. Thus, a U.S. citizen resident in the United Kingdom may claim benefits with respect to the United States under this article.

Article 26. Mutual Agreement Procedure

The proposed treaty contains the standard mutual agreement provision, with some variation, that authorizes the competent authorities of the two countries to consult together to attempt to alleviate individual cases of double taxation not in accordance with the proposed treaty. The saving clause of the proposed treaty does not apply to this article, so that the application of this article might result in a waiver (otherwise mandated by the proposed treaty) of taxing jurisdiction by the country of citizenship or residence.

Under this article, a resident of one country who considers that the action of one or both of the countries cause him or her to be subject to tax which is not in accordance with the provisions of the proposed treaty may (irrespective of internal law remedies) present his or her case to the competent authority of the country in which he or she is a resident or a national. Similar to the OECD model, and unlike the U.S. model, the proposed treaty provides that the case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the treaty (or, if later, within six years from the end of the taxable year or chargeable period with respect to which that tax is imposed or proposed).

The proposed treaty provides that if the objection appears to be justified and that competent authority is not itself able to arrive at a satisfactory solution, that competent authority must endeavor to resolve the case by mutual agreement with the competent authority of the other country, with a view to the avoidance of taxation which is not in accordance with the proposed treaty. The proposed

treaty provides that any agreement reached will be implemented notwithstanding any time limits or other procedural limitations under the domestic laws of either country (*e.g.*, a country's applicable statute of limitations). The notes provide an exception from this rule for such limitations as apply for purposes of giving effect to such agreements (*e.g.*, a domestic law requirement that the taxpayer file a return reflecting the agreement within a designated time period).

The notes provide that where the competent authorities are seeking to resolve a case pursuant to this article, neither country may seek to collect the tax that is in dispute until the mutual agreement procedure has been completed. However, the notes further provide that any tax that is payable following the completion of the mutual agreement procedure will be subject to applicable interest charges, surcharges, or penalties for so long as the tax remains unpaid.

The competent authorities of the countries are to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the proposed treaty. In particular, the competent authorities may agree to: (1) the same attribution of income, deductions, credits, or allowances of an enterprise of one treaty country to the enterprise's permanent establishment situated in the other country; (2) the same allocation of income, deductions, credits, or allowances between persons; (3) the same characterization of particular items of income, including the same characterization of income that is assimilated to income from shares by the tax laws of one country and that is treated as a different class of income in the other country; (4) the same characterization of persons; (5) the same application of source rules with respect to particular items of income; (6) a common meaning of a term; (7) that the conditions for the application of the conduit arrangement tests under the second sentence of paragraph 5 of Article 7 (Business Profits), paragraph 9 of Article 10 (Dividends), paragraph 7 of Article 11 (Interest), paragraph 5 of Article 12 (Royalties), or paragraph 4 of Article 22 (Other Income) have been met; and (8) the application of the provisions of each country's domestic law regarding penalties, fines, and interest in a manner consistent with the purposes of the proposed treaty. The Technical Explanation clarifies that this list is a non-exhaustive list of examples of the kinds of matters about which the competent authorities may reach agreement. With respect to item (7) above, the Technical Explanation states that if the competent authorities become aware of a type of tax avoidance transaction entered into by several taxpayers, it is anticipated that each competent authority will respond to that transaction by means of domestic laws and procedures, rather than through the issuance of a general agreement, in order to deny benefits in appropriate cases.

The proposed treaty provides that the competent authorities may consult together for the elimination of double taxation regarding cases not provided for in the proposed treaty. In addition, the notes provide that it is understood that any principle of general application established by an agreement between the competent authorities will be published by both competent authorities. This will increase transparency in the administration of the treaty by pro-

viding taxpayers with notification of principles of general applicability upon which both competent authorities have agreed.

The proposed treaty authorizes the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of this mutual agreement article. The Technical Explanation states that this provision makes clear that it is not necessary to go through diplomatic channels in order to discuss problems arising in the application of the proposed treaty.

The notes provide that the provisions of Article 26 (Mutual Agreement Procedure) of the proposed treaty will have effect from the date of entry into force of the proposed treaty, without regard to the taxable or chargeable period to which the matter relates.

Article 27. Exchange of Information and Administrative Assistance

The proposed treaty provides that the two competent authorities will exchange such information as is necessary¹⁹ to carry out the provisions of the proposed treaty, or the domestic laws of the two countries concerning taxes covered by the proposed treaty insofar as the taxation thereunder is not contrary to the proposed treaty, including for purposes of preventing fraud and facilitating the administration of statutory provisions against legal avoidance. This exchange of information is not restricted by Article 1 (General Scope). Therefore, information with respect to third-country residents is covered by these procedures. The two competent authorities may exchange information on a routine basis, on request in relation to a specific case, or spontaneously. The Technical Explanation states that it is contemplated that all of these types of exchange will be utilized, as appropriate.

Unlike the U.S. model, the proposed treaty is limited to taxes that are identified in Article 2 (Taxes Covered). The Technical Explanation states that U.K. legislation for implementing tax treaties does not provide authority to exchange information with respect to other types of taxes.

Any information exchanged under the proposed treaty is treated as secret in the same manner as information obtained under the domestic laws of the country receiving the information. The exchanged information may be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes to which the proposed treaty applies, or to persons or authorities engaged in the oversight of the above (*e.g.*, the tax-writing committees of Congress and the General Accounting Office). Such persons or authorities must use the information for such purposes only. Information received by these bodies must be for use in the performance of their role in overseeing the administration of U.S. tax laws. Exchanged information may be disclosed in public court proceedings or in judicial decisions.

¹⁹The U.S. model uses “relevant” instead of “necessary.” The Technical Explanation states that “necessary” has been consistently interpreted as being equivalent to “relevant,” and does not necessitate a demonstration that a State would be disabled from enforcing its tax laws absent the information.

If information is requested by a country in accordance with this article, the proposed treaty provides that the other country will obtain that information in the same manner and to the same extent as if the tax of the requesting country were the tax of the other country and were being imposed by that country, notwithstanding that such other country may not need such information at that time. The Technical Explanation states that a recent change in U.K. domestic law allows the United Kingdom to agree to this provision of the proposed treaty, and to obtain and exchange information in which it does not have a direct tax interest.

As is true under the U.S. model and the OECD model, under the proposed treaty, a country is not required to carry out administrative measures at variance with the laws and administrative practice of either country, to supply information that is not obtainable under the laws or in the normal course of the administration of either country, or to supply information that 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.

The notes provide that the powers of each country's competent authority to obtain information include the ability to obtain information held by financial institutions, nominees, or persons acting in an agency or fiduciary capacity. This does not include the ability to obtain information that would reveal confidential communications between a client and an attorney, solicitor, or other legal representative, where the client seeks legal advice. The Technical Explanation states that, in the case of the United States, the scope of the privilege for such confidential communications is coextensive with the attorney-client privilege under U.S. law. The notes also provide that the competent authorities may obtain information relating to the ownership of legal persons. The notes confirm that each country's competent authority is able to exchange such information in accordance with this article.

The proposed treaty provides that if specifically requested by the competent authority of a country, the competent authority of the other country must provide information under this article in the form of authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings), to the same extent such documents can be obtained under the laws and administrative practices of the requested country with respect to its own taxes. Unlike the U.S. model, the proposed treaty does not authorize the use of depositions of witnesses to obtain information under this article. The Technical Explanation states that under current U.K. law and practice, the U.K. Inland Revenue does not have the authority to take such depositions.

Under the proposed treaty, a country may collect on behalf of the other country such amounts as may be necessary to ensure that relief granted under the treaty by the other country does not inure to the benefit of persons not entitled thereto. However, neither country is obligated to carry out administrative measures that would be contrary to its sovereignty, security, or public policy.

Under the proposed treaty, the competent authority of a country intending to send its officials to the other country to interview individuals and examine books and records with the consent of the per-

son subject to examination must notify the competent authority of the other country of such intention.

Like the present treaty, the proposed treaty provides that the competent authorities will consult with each other for purposes of cooperating and advising in respect of any action to be taken in implementing this article.

The notes provide that the provisions of Article 27 (Exchange of Information and Administrative Assistance) of the proposed treaty will have effect from the date of entry into force of the proposed treaty, without regard to the taxable or chargeable period to which the matter relates.

Article 28. Diplomatic Agents and Consular Officers

The proposed treaty contains the rule found in the U.S. model, the present treaty, and other U.S. tax treaties that its provisions do not affect the fiscal privileges of diplomatic agents or consular officers under the general rules of international law or under the provisions of special agreements. Accordingly, the proposed treaty will not defeat the exemption from tax which a host country may grant to the salary of diplomatic officials of the other country. The saving clause does not apply in the application of this article to host country residents who are neither citizens nor lawful permanent residents of that country. Thus, for example, U.S. diplomats who are considered U.K. residents may be protected from U.K. tax.

Article 29. Entry Into Force

The proposed treaty provides that the treaty is subject to ratification in accordance with the applicable procedures of each country, and that instruments of ratification will be exchanged as soon as possible. The proposed treaty will enter into force upon the exchange of instruments of ratification.

With respect to the United States, the proposed treaty will be effective with respect to taxes withheld at source for amounts paid or credited on or after the first day of the second month following the date on which the proposed treaty enters into force. With respect to other taxes, the proposed treaty will be effective for taxable periods beginning on or after the first day of January next following the date on which the proposed treaty enters into force.

With respect to the United Kingdom, the proposed treaty will be effective with respect to taxes withheld at source for amounts paid or credited on or after the first day of the second month following the date on which the proposed treaty enters into force. With respect to income taxes not described in the preceding sentence and with respect to capital gains taxes, the proposed treaty will be effective for any year of assessment beginning on or after the sixth day of April next following the date on which the proposed treaty enters into force. With respect to the corporation tax, the proposed treaty will be effective for any financial year beginning on or after the first day of April next following the date on which the proposed treaty enters into force.²⁰ With respect to petroleum revenue taxes,

²⁰ Thus, with respect to these taxes, the proposed treaty would take effect almost immediately if instruments of ratification were exchanged in March 2003; otherwise, the earliest it could take effect with respect to these taxes would be for financial years or years of assessment beginning in April 2004.

the proposed treaty will be effective for chargeable periods beginning on or after the first day of January next following the date on which the proposed treaty enters into force.

The present treaty generally will cease to have effect in relation to any tax from the date on which the proposed treaty takes effect in relation to that tax. Taxpayers may elect temporarily to continue to claim benefits under the present treaty with respect to a period after the proposed treaty takes effect. For such a taxpayer, the present treaty would continue to have effect in its entirety for a twelve-month period from the date on which the provisions of the proposed treaty would otherwise take effect. The present treaty will terminate on the last date on which it has effect in relation to any tax in accordance with the provisions of this article.

Notwithstanding the entry into force of the proposed treaty, an individual who is entitled to the benefits of Article 21 (Students and Trainees) of the present treaty at the time the proposed treaty enters into force will continue to be entitled to such benefits as if the present treaty remained in force. The Technical Explanation states that the treatment of trainees under the present treaty may be more generous than under the proposed treaty (which generally limits benefits for such individuals for up to one year). The Technical Explanation states that the special rule in the proposed treaty was included so that the rules do not change with respect to certain trainees that have based their decisions to come to a host country on the assumption that the benefits of the present treaty would apply to them.

The notes provide that the provisions of Article 26 (Mutual Agreement Procedure) and Article 27 (Exchange of Information and Administrative Assistance) of the proposed treaty will have effect from the date of entry into force of the proposed treaty, without regard to the taxable or chargeable period to which the matter relates.

Article 30. Termination

The proposed treaty will remain in force until terminated by either country. Either country may terminate the proposed treaty by giving notice of termination to the other country through diplomatic channels. In such case, with respect to the United States, a termination is effective with respect to taxes withheld at source for amounts paid or credited after six months following notice of termination. With respect to other taxes, a termination is effective for taxable periods beginning on or after the date that is six months following notice of termination.

With respect to the United Kingdom, a termination is effective with respect to taxes withheld at source for amounts paid or credited after six months following notice of termination. With respect to income taxes not described in the preceding sentence and with respect to capital gains taxes, a termination is effective for any year of assessment beginning on or after the date that is six months following the notice of termination. With respect to the corporation tax, a termination is effective for any financial year beginning on or after the date that is six months following notice of termination. With respect to the petroleum revenue tax, a termination

is effective for chargeable periods beginning on or after the date that is six months following notice of termination.

Other Matters

The notes provide that the two countries will consult together at regular intervals regarding the terms, operation, and application of the proposed treaty to ensure that it continues to serve the purpose of avoiding double taxation and preventing fiscal evasion, and where appropriate, conclude protocols to amend the proposed treaty. The notes provide that the first consultation will take place no later than December 31 of the fifth year following the date on which the proposed treaty enters into force. The notes further provide that subsequent consultations will take place in intervals of no more than five years.

Notwithstanding the above, the notes provide that either country may at any time request consultations with the other country with respect to matters relating to the terms, operation, and application of the proposed treaty that it considers require urgent resolution.

IV. ISSUES

A. Zero Rate of Withholding Tax on Dividends From 80-Percent-Owned Subsidiaries

In general

The proposed treaty would eliminate withholding tax on dividends paid by one corporation to another corporation that owns at least 80 percent of the stock of the dividend-paying corporation (often referred to as “direct dividends”), provided that certain conditions are met (subparagraph 3(a) of Article 10 (Dividends)). The elimination of withholding tax under these circumstances is intended to reduce further the tax barriers to direct investment between the two countries.

Unlike the United States, the United Kingdom currently does not impose withholding tax on dividends paid to foreign shareholders as a matter of domestic law. Thus, the principal immediate effect of this provision would be to exempt dividends that U.S. subsidiaries pay to U.K. parent companies from U.S. withholding tax. With respect to dividends paid by U.K. subsidiaries to U.S. parent companies, the effect of this provision would be to lock in the currently applicable zero rate of U.K. withholding tax, regardless of how U.K. domestic law might change in this regard.

Currently, no U.S. treaty provides for a complete exemption from withholding tax under these circumstances, nor do the U.S. or OECD models. However, many bilateral tax treaties to which the United States is not a party eliminate withholding taxes under similar circumstances, and the same result has been achieved within the European Union under its “Parent-Subsidiary Directive.” In addition, subsequent to the signing of the proposed treaty, the United States signed proposed protocols with Australia and Mexico that include zero-rate provisions similar to the one in the proposed treaty.

Description of provision

Under the proposed treaty, the withholding tax rate is reduced to zero on dividends beneficially owned by a company that has owned at least 80 percent of the voting power of the company paying the dividend for the 12-month period ending on the date the dividend is declared (subparagraph 3(a) of Article 10 (Dividends)). Under the current U.S.-U.K. treaty, these dividends may be taxed at a 5-percent rate (although, as noted above, the United Kingdom currently does not exercise this right as a matter of domestic law, whereas the United States does).

In certain circumstances, eligibility for the zero rate under the proposed treaty is subject to an additional restriction designed to prevent companies from reorganizing for the purpose of obtaining the benefits of the provision. Specifically, in cases in which a com-

pany satisfies the Limitation on Benefits article only under the “active trade or business” and/or “ownership/base-erosion” tests (paragraph 4 and subparagraph 2(f), respectively, of Article 23 (Limitation on Benefits)), the zero rate will apply only if the dividend-receiving company owned (directly or indirectly) at least 80 percent of the voting power of the dividend-paying company prior to October 1, 1998.²¹ In other cases, the Limitation on Benefits article itself is considered sufficient to prevent treaty shopping. Thus, companies that qualify for treaty benefits under the “public trading,” “derivative benefits,” or discretionary tests (subparagraph 2(c) and paragraphs 3 and 6, respectively, of Article 23 (Limitation on Benefits)) will not need to meet the October 1, 1998 holding requirement in order to claim the zero rate.²²

Issues

In general

Given that the United States has never before agreed bilaterally to a zero rate of withholding tax on direct dividends, the Committee may wish to devote particular attention to the benefits and costs of taking this step. The Committee also may want to determine whether the inclusion of the zero-rate provision in the proposed treaty (as well as in the proposed protocols with Australia and Mexico) signals a broader shift in U.S. treaty policy, and under what circumstances the United States may seek to include similar provisions in other treaties. Finally, the Committee may wish to note the ramifications of including this provision in the U.S.-U.K. treaty in view of a “most favored nation” provision relating to this subject in the current U.S.-Mexico treaty.

Benefits and costs of adopting a zero rate with the United Kingdom

Tax treaties mitigate double taxation by resolving the potentially conflicting claims of a residence country and a source country to tax the same item of income. In the case of dividends, standard international practice is for the source country to yield mostly or entirely to the residence country. Thus, the residence country preserves its right to tax the dividend income of its residents, and the source country agrees either to limit its withholding tax to a relatively low rate (e.g., 5 percent) or to forgo it entirely.

Treaties that permit a positive rate of dividend withholding tax allow some degree of double taxation to persist. To the extent that the residence country allows a foreign tax credit for the withholding tax, this remaining double taxation may be mitigated or eliminated, but then the priority of the residence country’s claim to tax the dividend income of its residents is not fully respected. Moreover, if a residence country imposes limitations on its foreign tax credit,²³ withholding taxes may not be fully creditable as a practical matter, thus leaving some double taxation in place. For

²¹ October 1, 1998 is the date on which the parties announced that they were negotiating the proposed treaty.

²² See Part III, Article 10, *supra*, for a discussion of an interpretive issue that arose regarding the scope of the zero-rate provision under the language of the proposed treaty as originally signed, prior to amendment by the proposed protocol.

²³ See, e.g., Code sec. 904.

these reasons, dividend withholding taxes are commonly viewed as barriers to cross-border investment. The principal argument in favor of eliminating withholding taxes on certain direct dividends in the proposed treaty is that it would remove one such barrier.

Direct dividends arguably present a particularly appropriate case in which to remove the barrier of a withholding tax, in view of the close economic relationship between the payor and the payee. Whether in the United States or in the United Kingdom, the dividend-paying corporation generally faces full net-basis income taxation in the source country, and the dividend-receiving corporation generally is taxed in the residence country on the receipt of the dividend (subject to allowable foreign tax credits). If the dividend-paying corporation is at least 80-percent owned by the dividend-receiving corporation, it is arguably appropriate to regard the dividend-receiving corporation as a direct investor (and taxpayer) in the source country in this respect, rather than regarding the dividend-receiving corporation as having a more remote investor-type interest warranting the imposition of a second-level source-country tax.

Since the United Kingdom does not impose a withholding tax on these dividends under its internal law, the zero-rate provision would principally benefit direct investment in the United States by U.K. companies, as opposed to direct investment in the United Kingdom by U.S. companies. In other words, the potential benefits of the provision would accrue mainly in situations in which the United States is importing capital, as opposed to exporting it.²⁴

In this regard, the Committee may wish to note that adopting a zero-rate provision in the U.S.-U.K. treaty would have uncertain revenue effects for the United States. The United States would forgo the 5-percent tax that it currently collects on qualifying dividends paid by U.S. subsidiaries to U.K. parent companies, but since the United Kingdom currently does not impose any tax on comparable dividends paid by U.K. subsidiaries to U.S. parent companies, there would be no offsetting revenue gain to the United States in the form of decreased foreign tax credit claims with respect to withholding taxes.²⁵ However, in order to account for the recent repeal of the U.K. advance corporation tax and related developments, the proposed treaty also eliminates a provision of the present treaty requiring the United States to provide a foreign tax credit with respect to certain dividends received from U.K. companies. On balance, these two effects are likely to increase revenues for the U.S. fisc. Over the longer term, if capital investment in the United States by U.K. persons is made more attractive, total investment in the United States may increase, ultimately creating a larger domestic tax base. However, if increased investment in the United States by U.K. persons displaced other foreign or U.S. in-

²⁴ In contrast, including a similar provision in a treaty with a country that does impose withholding tax on some or all direct dividends under its internal law (e.g., Australia) would provide more immediate and direct benefits to the United States as both an importer and an exporter of capital.

²⁵ The overall revenue impact of including a similar provision in a treaty with a country that does impose withholding tax on direct dividends would be more favorable for the United States, as the direct revenue loss to the United States as a source country would be offset in whole or in part by a revenue gain as a residence country from reduced foreign tax credit claims with respect to withholding taxes.

vestments in the United States, there would be no increase in the domestic tax base.

Revenue considerations aside, the removal of an impediment to the import of capital from the United Kingdom into the United States is a not-inconsiderable economic benefit. Further, it should be noted that, although U.K. internal law currently does not impose a withholding tax on dividends paid to foreign persons, there is no guarantee that this will always be the case. Thus, the inclusion of a zero-rate provision in the treaty would give U.S.-based enterprises somewhat greater certainty as to the applicability of a zero rate in the United Kingdom, which arguably would facilitate long-range business planning for U.S. companies in their capacities as capital exporters. Along the same lines, the provision would protect the U.S. fisc against increased foreign tax credit claims in the event that the U.K. were to change its internal law in this regard.

Although the United States has never agreed bilaterally to a zero rate of withholding tax on direct dividends, many other countries have done so in one or more of their bilateral tax treaties. These countries include OECD members Austria, Denmark, France, Finland, Germany, Iceland, Ireland, Japan, Luxembourg, Mexico, the Netherlands, Norway, Sweden, Switzerland, and the United Kingdom, as well as non-OECD-members Belarus, Brazil, Cyprus, Egypt, Estonia, Israel, Latvia, Lithuania, Mauritius, Namibia, Pakistan, Singapore, South Africa, Ukraine, and the United Arab Emirates. In addition, a zero rate on direct dividends has been achieved within the European Union under its "Parent-Subsidiary Directive." Finally, many countries have eliminated withholding taxes on dividends as a matter of internal law (*e.g.*, the United Kingdom and Mexico). Thus, although the zero-rate provision in the proposed treaty is unprecedented in U.S. treaty history, there is substantial precedent for it in the experience of other countries. It may be argued that this experience constitutes an international trend toward eliminating withholding taxes on direct dividends, and that the United States would benefit by joining many of its treaty partners in this trend and further reducing the tax barriers to cross-border direct investment.

General direction of U.S. tax treaty policy

Looking beyond the U.S.-U.K. treaty relationship, the Committee may wish to determine whether the inclusion of the zero-rate provision in the proposed treaty (as well as in later-signed proposed protocols with Australia and Mexico) signals a broader shift in U.S. tax treaty policy. Specifically, the Committee may want to know whether the Treasury Department: (1) intends to pursue similar provisions in other proposed treaties in the future; (2) proposes any particular criteria for determining the circumstances under which a zero-rate provision may be appropriate or inappropriate; (3) expects to seek terms and conditions similar to those of the proposed treaty in connection with any zero-rate provisions that it may negotiate in the future; and (4) intends to amend the U.S. model to reflect these developments.²⁶ In light of the fact that the United

²⁶ More broadly, since the U.S. Model has not been updated since 1996, the Committee may wish to ask whether the Treasury Department intends to update the model to reflect all relevant developments that have occurred in the intervening years. A thoroughly updated model

States would stand to benefit more comprehensively from zero-rate provisions in treaties with countries that currently impose withholding taxes on the relevant dividends, the general implications of this first zero-rate provision are likely to be of greater interest in the United States than the particular implications with respect to the United Kingdom.

“Most favored nation” agreement with Mexico

The adoption of a zero-rate provision in the U.S.-U.K. treaty relationship may have particular ramifications for the U.S.-Mexico treaty relationship. Under the current U.S.-Mexico income tax treaty, dividends beneficially owned by a company that owns at least 10 percent of the voting stock of the dividend-paying company are subject to a maximum withholding rate of 5 percent (paragraph 2(a) of Article 10 of the U.S.-Mexico treaty), which is the lowest rate of withholding tax on dividends currently available under U.S. treaties. Under Protocol 1 to that treaty, as modified by a formal understanding subject to which the treaty and protocol were ratified, the United States and Mexico have agreed, if the United States adopts a rate on dividends lower than 5 percent in a treaty with another country, “to promptly amend [the U.S.-Mexico treaty] to incorporate that lower rate.”²⁷

Adopting the zero-rate provision in the proposed treaty would trigger this obligation to amend the current treaty with Mexico. The recently signed proposed protocol with Mexico would amend that treaty to incorporate a zero-rate provision substantially identical to that of the proposed treaty with the United Kingdom, and thus would seem to fulfill the U.S. obligation under the “most favored nation” agreement. Thus, if the Senate were to ratify both the proposed treaty with the United Kingdom and the proposed protocol with Mexico, no issues of interaction between the two treaty relationships would need to be confronted.

If, on the other hand, the Senate were to ratify the proposed treaty with the United Kingdom, but not the proposed protocol with Mexico, then the possibility would arise that the United States eventually could be regarded as falling out of compliance with its obligations under the U.S.-Mexico treaty. This would raise difficult questions as to the exact nature of this obligation and whether and how the United States would come into compliance with it.

would provide a more meaningful and useful guide to current U.S. tax treaty policy and would thereby increase transparency and facilitate Congressional oversight in this important area. See Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001, Vol. II, at 445-47 (recommending that the Treasury Department revise U.S. model tax treaties once per Congress).

²⁷This formal understanding was a response to an objection raised by the Committee to the original language of the treaty protocol, under which the “most-favored nation” provision would have been self-executing—*i.e.*, immediately upon U.S. agreement to a lower rate with another treaty partner, the United States and Mexico would have begun applying that lower rate in their treaty.

B. Anti-Conduit Rule

In general

The proposed treaty includes an anti-conduit rule that can operate to deny the benefits of the dividends article (Article 10), the interest article (Article 11), the royalties article (Article 12), the other income article (Article 22), and the insurance excise tax provision of the business profits article (Article 7(5)).²⁸ This rule is not found in any other U.S. treaty, and it is not included in the U.S. or OECD models. The rule is similar to, but significantly narrower and more precise than, the “main purpose” rules that the Senate rejected in 1999 in connection with its consideration of the U.S.-Italy and U.S.-Slovenia treaties.²⁹

The rule was included at the request of the United Kingdom, which has similar provisions in many of its tax treaties. The purpose of the rule, from the U.K. perspective, is to prevent residents of third countries from improperly obtaining the reduced rates of U.K. tax provided under the treaty by channeling payments to a third-country resident through a U.S. resident (acting as a “conduit”).

From the U.S. perspective, the rule is unnecessary, because U.S. domestic law provides detailed rules governing arrangements to reduce U.S. tax through the use of conduits.³⁰ Thus, apart from accommodating the request of a treaty partner, no apparent U.S. interest is served by adding a general anti-conduit rule to the treaty.

Description of provision

Under the proposed anti-conduit rule, the benefits of the dividends, interest, royalties, and other income articles are denied in connection with any payment made under, or as part of, a “conduit arrangement” (Articles 10(9), 11(7), 12(5), and 22(4), respectively). Article 3(1)(n) defines the term “conduit arrangement” as a transaction or series of transactions that meets both of the following criteria: (1) a resident of one contracting state receives an item of income that generally would qualify for treaty benefits, and then pays (directly or indirectly, at any time or in any form) all or substantially all of that income to a resident of a third state who would not be entitled to equivalent or greater treaty benefits if it had received the same item of income directly; and (2) obtaining the increased treaty benefits is the main purpose or one of the main purposes of the transaction or series of transactions.

The inclusion of the first criterion above limits the scope of the rule to situations involving objectively defined conduit payments. Thus, the rule is less vague and more narrowly targeted than the

²⁸The issues raised by the proposed anti-conduit rule in the context of the insurance excise tax differ from those raised in connection with the other articles. Issues relating to the insurance excise tax are discussed separately in Part IV.C of this pamphlet. The present discussion of the rule is limited to the issues raised in the context of the dividends, interest, royalties, and other income articles.

²⁹See Senate Committee on Foreign Relations, *Report, Tax Convention with Italy*, Exec. Rpt. 106–8, Nov. 3, 1999; Senate Committee on Foreign Relations, *Report, Tax Convention with Slovenia*, Exec. Rpt. 106–7, Nov. 3, 1999; see also Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty and Proposed Protocol between the United States and the Italian Republic* (JCS–9–99), October 8, 1999; Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty between the United States and the Republic of Slovenia* (JCS–11–99), October 8, 1999.

³⁰See Code sec. 7701(l); Treas. Reg. sec. 1.881–3.

similar rules that the Senate rejected in the proposed U.S.-Italy and U.S.-Slovenia treaties, which would have applied to any transaction that met a “main purpose” test similar to the second criterion described above.

Issues

Although the proposed anti-conduit rule is considerably narrower and more objective than the similar rules rejected by the Senate in 1999, the rule is also without precedent in existing U.S. tax treaties, and thus the Committee may wish to give it particular attention.

The rule may create confusion, because it applies not only to conduit arrangements in which a reduction in U.K. tax is claimed, but also to conduit arrangements in which a reduction in U.S. tax is claimed, despite the fact that there is no apparent reason for the rule to apply in the latter circumstance, in view of the existence of anti-conduit provisions under U.S. domestic law. To the extent that the proposed treaty’s anti-conduit rule and the U.S. domestic-law anti-conduit rules are not consistent in every particular, taxpayers may be confused as to which set of rules the United States will apply in certain situations.³¹

In order to mitigate this potential confusion, as well as to provide guidance as to how the United Kingdom will apply the anti-conduit rule in situations in which a reduction in U.K. tax is claimed, the parties executed an exchange of letters in July 2002, in which they described in some detail how they intend to apply the anti-conduit rule.³²

The U.S. letter suggests that the United States simply will continue to apply its domestic law, without regard to the treaty rule:

With respect to the United States, we intend to interpret the conduit arrangement provisions of the Convention in accordance with U.S. domestic law as it may evolve over time. The relevant law currently includes in particular the rules of regulation section 1.881–3 and other regulations adopted under the authority of section 7701(l) of the Internal Revenue Code. Therefore, the inclusion of the conduit arrangement rules in the Convention does not constitute an expansion (or contraction) of U.S. domestic anti-abuse principles (except with respect to the application of anti-conduit principles to the insurance excise tax).³³

³¹For example, the anti-conduit rules of U.S. domestic law currently do not apply to transactions involving dividend payments on common stock, but the anti-conduit rule in the proposed treaty could apply to such transactions. (The Treasury Department has the authority under Code section 7701(l) to apply anti-conduit principles to these transactions, but it has not exercised this authority.)

³²See Letter from Barbara M. Angus, International Tax Counsel, Department of the Treasury, to Gabriel Makhoul, Director, Inland Revenue, International Division, July 19, 2002 (the “U.S. letter”); Letter from Gabriel Makhoul, Director, Inland Revenue, International Division, to Barbara M. Angus, International Tax Counsel, Department of the Treasury, July 19, 2002 (the “U.K. letter”). These letters are appended to the Technical Explanation.

³³U.S. letter, at 1. Similar language appears in the Technical Explanation to article 3(1).

An annex to the U.S. letter provides six examples illustrating how the United States intends to apply the rule in a manner consistent with current U.S. domestic law.³⁴

This statement of intent from the U.S. perspective should substantially mitigate the potential uncertainty regarding how the United States will treat conduit arrangements. Nevertheless, some may find it difficult to understand why, given this intent, the rule in the proposed treaty was drafted to apply to situations addressed by U.S. domestic law in the first place.

The U.K. letter includes an annex that evaluates examples analogous to those set forth in the annex to the U.S. letter, reaching results consistent with those of the U.S. letter. The U.K. letter thus provides helpful guidance as to how the anti-conduit rules of the proposed treaty will be applied in cases in which a reduction in U.K. tax is claimed.

The Committee may wish to satisfy itself that these measures adequately address the potential confusion and uncertainty that could arise from including an anti-conduit rule in the proposed treaty. The Committee also may wish to satisfy itself that the Treasury Department has agreed to this provision solely as an accommodation to the United Kingdom and does not intend to include similar provisions in future treaties.

C. Insurance Excise Tax

The proposed treaty, like the present treaty, waives the application of the U.S. insurance excise tax on foreign insurers and reinsurers. Thus, for example, a U.K. insurer or reinsurer generally may receive premiums on policies with respect to U.S. risks free of this tax. As further discussed below, waiver of this tax may raise concerns if a substantial tax is not imposed by the United Kingdom or a third country on the foreign insurer or reinsurer.

Unlike the present treaty, the proposed treaty incorporates an anti-conduit rule to prevent persons not entitled to equivalent or more favorable treaty benefits from obtaining the benefit of the insurance excise tax waiver under the proposed treaty. The addition of an anti-conduit rule in the proposed treaty makes the proposed treaty more comparable than the present treaty to other U.S. treaties that provide waivers of the application of the insurance excise tax (with anti-conduit rules). Thus, the rule of the proposed treaty may be viewed as an improvement over the rule of the present treaty, which provides a waiver of the insurance excise tax without any anti-conduit rule.

The anti-conduit rule in the proposed treaty differs from insurance excise tax anti-conduit rules in other U.S. tax treaties; in particular, the rule in the proposed treaty incorporates a “main purpose” test. That is, the anti-conduit rule in the proposed treaty applies only if the conduit arrangement has as its main purpose, or one of its main purposes, obtaining such increased benefits as are available under the proposed treaty. The main purpose test apparently is modeled after similar “main purpose” provisions found in

³⁴For example, the letter indicates that the United States will not apply anti-conduit principles to a transaction involving dividends on common stock, because the transaction is not covered by the current U.S. domestic anti-conduit rules. Annex to the U.S. letter, Example 2.

treaties of other countries, such as many of the modern treaties of the United Kingdom. The “main purpose” aspect of the proposed treaty’s anti-conduit rule presents some issues. Specifically, the test is subjective and lacks conformity with the relevant provisions of most other U.S. tax treaties.

The Technical Explanation to the proposed treaty, however, states that the United States intends to interpret the conduit arrangement provisions of the proposed treaty in accordance with U.S. domestic law, as it may evolve over time, and further states in the context of the waiver of the insurance excise tax that the United States will interpret the provision of the proposed treaty by analogy to the anti-conduit rules of regulation section 1.881-3. The interpretation of the anti-conduit rule as applied to the insurance excise tax waiver in the proposed treaty in a manner consistent with U.S. law may be different from the interpretation and application of insurance excise tax anti-conduit rules in other U.S. treaties.

Waivers of the insurance excise tax in other treaties have raised serious congressional concerns. For example, concern has been expressed over the possibility that such waivers may place U.S. insurers at a competitive disadvantage with respect to foreign competitors in U.S. markets if a substantial tax is not otherwise imposed (*e.g.*, by the treaty partner country) on the insurance income of the foreign insurer or reinsurer.³⁵ Moreover, in such a case, a waiver of the tax does not serve the primary purpose of treaties to prevent double taxation, but instead has the undesirable effect of eliminating all tax on such income.

The U.S.-Barbados and U.S.-Bermuda tax treaties each contained such a waiver as originally signed. In its report on the Bermuda treaty, the Committee expressed the view that those waivers should not have been included. The Committee stated that waivers should not be given by Treasury in its future treaty negotiations without prior consultations with the appropriate committees of Congress. Congress subsequently enacted legislation to ensure the sunset of the waivers in the two treaties.

The Committee may wish to satisfy itself that the U.K. tax imposed on U.K. insurers and reinsurers on premium income results in a burden that is substantial in relation to the U.S. tax on U.S. insurers and reinsurers, and that the anti-conduit rule in the proposed treaty is sufficient to prevent persons not entitled to equivalent or more favorable treaty benefits from obtaining the benefit of the insurance excise tax waiver.

D. Dividend Substitute Payments

The proposed treaty provides that, in the case of a dividend paid by a U.S. company to a U.K. company that directly or indirectly controls at least 10 percent of the voting power of the U.S. company, the U.K. company generally is eligible for a credit against U.K. tax for U.S. taxes that are payable by the U.S. company in respect of the profits out of which such dividend is paid.

³⁵ See, *e.g.*, U.S. Treasury Department, *Report to Congress on the Effect on U.S. Reinsurance Corporations of the Waiver by Treaty of the Excise Tax on Certain Reinsurance Premiums*, 90 TNT 71-31 (March 1990).

However, the proposed treaty also provides an anti-abuse rule that eliminates the U.K. indirect credit in certain circumstances if the U.K. company receives an amount from a U.S. resident that is equivalent to a dividend from the U.S. company but is not an actual dividend from the U.S. company (*i.e.*, a dividend substitute payment). Specifically, the proposed treaty provides that a U.K. company is not eligible for a credit against U.K. tax for U.S. taxes paid if and to the extent that (1) the United Kingdom treats the dividend from the U.S. company as beneficially owned by a U.K. resident, (2) the United States treats the same dividend as beneficially owned by a U.S. resident, and (3) the United States allows a deduction to a resident of the United States in respect of an amount determined by reference to the dividend. This anti-abuse provision is not found in any other U.S. treaty, and is not included in the U.S. model or the OECD model.

The Technical Explanation provides the following example to illustrate the operation of the exception for certain dividend substitute payments: A U.S. holding company sells stock in another U.S. company to a U.K. company. Simultaneously, the U.S. holding company enters into a repurchase agreement with the U.K. company that allows the U.S. holding company to buy back the stock at a predetermined price. The sale and the repurchase agreement are structured in such a way that the transactions are treated together as a loan for U.S. tax purposes (with the dividends paid to the U.K. company treated as payments of interest on a loan from the U.K. company to the U.S. company). Because U.K. domestic law provides no mechanism for similarly treating the sale and repurchase in accordance with its economic substance, the United Kingdom would be required to respect the form of the transaction as a sale and grant an indirect credit with respect to dividends from the U.S. company, resulting in double non-taxation of income.

In general, there are several types of cross-border transactions (often referred to as “hybrid” transactions) that take advantage of the interaction between (or among) the tax laws of two (or more) jurisdictions, which can independently give rise to different tax consequences under each country’s laws with respect to the same transaction.³⁶ Some commentators argue that the interaction between U.S. domestic tax laws and foreign tax laws can lead to unwarranted tax arbitrage opportunities for taxpayers, particularly when the foreign laws and the U.S. tax rules yield inconsistent tax results for the same transaction.³⁷ However, others contend that the potential for tax arbitrage in cross-border transactions is an unavoidable and acceptable consequence of different laws and complex tax systems in the U.S. and other countries that reflect the individual policy decisions of each jurisdiction. In any case, many commentators argue that efforts to combat cross-border tax arbitrage should be addressed in general provisions of domestic law

³⁶For a more detailed discussion of the cross-border tax issues concerning the interaction of U.S. Federal tax laws with the laws of foreign countries and tax treaties, see Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001 (vol. 1, pages 93–100).

³⁷For further discussion and analysis of the issues raised by cross-border hybrid transactions, see Joint Committee on Taxation, *Description of Revenue Provisions Contained in the Fiscal Year 1999 Budget Proposal* (JCS-4-98), February 24, 1998, at 193–196.

rather than specific tax treaty provisions of limited jurisdictional and transactional scope.³⁸

The issue raised by the dividend substitute payment provision in the proposed treaty concerns the extent to which treaties should depart from the U.S. model to address transactional tax arbitrage and, specifically, whether the proposed treaty should address cross-border transactions in a manner that is categorically limited to a specific type of transaction and, by definition, is limited to transactions involving the United States and the United Kingdom.³⁹ The provision could be characterized as being simultaneously too narrow and too broad. The provision might be too narrow in the sense that it may be readily avoided through transactions that are economically equivalent to the transactions covered by the provision but, for example, involve payments other than dividend substitute payments. On the other hand, the provision might be too broad in that it applies to all transactions that meet the specified conditions, without regard to whether the transaction was entered into for tax-motivated purposes or for legitimate business reasons.⁴⁰ In this respect, the provision is broader than the conduit arrangement provision in the proposed treaty, which only applies if a main purpose of the transaction is to obtain increased benefits under the proposed treaty. In addition, whereas the conduit arrangement provision can preclude either U.S. or U.K. tax benefits under the proposed treaty, the provision concerning dividend substitute payments only provides for the loss of U.K. tax benefits (*i.e.*, U.K. indirect foreign tax credits) rather than U.S. tax benefits (*e.g.*, dividend substitute payment deductions), although the very application of the provision is contingent upon the deductibility of the payments under U.S. domestic tax law.

The Committee might wish to consider the advisability of a treaty anti-abuse provision that is limited to denying U.K. indirect foreign tax credits for specific types of cross-border transactions, par-

³⁸For example, although most recent U.S. tax treaties address structural cross-border tax arbitrage (among other things) with provisions concerning fiscally transparent entities, Congress enacted 894(c) in 1997 (Pub. L. No. 105-34) to deny certain treaty benefits to foreign persons with regard to items of income derived through U.S. entities that are treated as partnerships (or are otherwise treated as fiscally transparent) for U.S. tax purposes. In addition, section 894(c) authorizes the Secretary of the Treasury to prescribe regulations to determine, in situations other than the situation specifically described in the statutory provision, the extent to which a taxpayer shall not be entitled to benefits under an income tax treaty of the United States with respect to any payment received by, or income attributable to activities of, an entity that is treated as a partnership for U.S. Federal income tax purposes (or is otherwise treated as fiscally transparent for such purposes) but is treated as fiscally non-transparent for purposes of the tax laws of the jurisdiction of residence of the taxpayer.

³⁹Because the provision is limited on a transactional basis to dividend substitute payments, it does not apply to several other types of cross-border tax arbitrage transactions. For example, the provision does not apply to multiple depreciation deductions that can be obtained through certain cross-border leasing transactions in which a taxpayer retains legal title to leased property in a country that provides depreciation deductions based upon legal (rather than economic) ownership of property, and transfers economic ownership of property to another party in a different country in which depreciation deductions are based upon economic (rather than legal) ownership. The provision is also limited on a jurisdictional basis to dividend substitute payments that are made to the U.K. By contrast, although Congress enacted section 894(c) in response specifically to the use of fiscally transparent U.S. subsidiaries by Canadian corporations to obtain multiple tax benefits, section 894(c) is not limited to transactions involving Canada.

⁴⁰The Technical Explanation suggests that the provision is targeted appropriately because it will only apply with respect to transactions involving persons who own more than 10 percent of the U.S. company paying the dividends. The Technical Explanation states further that the repurchase price with respect to most sale-repurchase agreements reflects the current cost of funds, and is not determined by reference to the dividends paid on the stock. Consequently, the Technical Explanation concludes that the provision should not (and is not intended to) affect most sale-repurchase agreements and similar transactions that take place in the public markets.

ticularly if the provision in the proposed treaty can be avoided through transactions that are economically equivalent to the transactions covered by the provision. In addition, because the provision is unique to the proposed treaty and the application of the provision is not conditioned upon the presence of a tax-motivated purpose, the Committee might wish to consider whether the provision could have the unintended effect of discouraging certain legitimate non-tax motivated cross-border securities repurchase and securities lending arrangements between taxpayers in the United States and the United Kingdom, particularly in relation to such transactions between taxpayers in the United States and another country. The Committee also might wish to consider under which circumstances rules against transactional tax arbitrage are more appropriately implemented in generally applicable U.S. domestic tax laws rather than narrow provisions in tax treaties with certain countries.

E. Attribution of Business Profits

Background

Present treaty

The present treaty provides that business profits are attributed to a permanent establishment based upon an arm's-length pricing approach in which the permanent establishment is allocated an amount of profits that it might be expected to earn if it were a distinct and separate enterprise that is engaged in the same or similar activities under the same or similar conditions and deals wholly independently with the enterprise of which it is a permanent establishment (often referred to as the "separate enterprise" principle). In determining the amount of business profits attributable to a permanent establishment, the present treaty provides for the deduction of expenses incurred for the purposes of the permanent establishment, including a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole (or the part of the enterprise that includes the permanent establishment), whether incurred in the treaty country in which the permanent establishment is situated or elsewhere.

In general, the present treaty follows the OECD model in its approach to attributing business profits to a permanent establishment. Nevertheless, the rules under the present treaty for the attribution of business profits to a permanent establishment have been the subject of considerable commentary and debate, particularly in relation to U.S. domestic tax rules for determining the amount of interest expense that a foreign corporation may deduct against the U.S. taxable income of the foreign corporation.

U.S. domestic tax law

Under the general authority of section 482, U.S. domestic tax law provides the Secretary of the Treasury the power to make reallocations wherever necessary in order to prevent evasion of taxes or to clearly reflect the income of related enterprises. Under regulations, the Treasury Department implements this authority using an arm's-length standard, and has indicated its belief that the standard it applies under section 482 is fully consistent with the arm's-

length standard provided in most U.S. tax treaties, including the present and proposed treaties with the United Kingdom.⁴¹

For purposes of determining the amount of interest expense that a foreign corporation engaged in a U.S. trade or business is permitted to deduct against U.S. taxable income, U.S. domestic tax law requires the use of an allocation formula that generally involves measuring the total assets and liabilities of a U.S. trade or business with a “constructed” (rather than actual) balance sheet for the U.S. trade or business, and then apportioning the interest expense (using a mathematical formula) among the tax jurisdictions that claim primary taxing rights over the portions of the whole enterprise of which the U.S. trade or business is a part.⁴² In contrast to this method, allocations using an arm’s-length standard generally are based upon the actual business records and accounts of the enterprise, including the records of branches on the basis of treating them as distinct and separate enterprises, with any adjustments that may be necessary to impute adequate capital to the branches and to ensure that any interbranch transactions taken into account have economic substance and market pricing.

In applying an allocation formula to determine U.S. interest expense, the U.S. domestic tax laws require the foreign corporation to completely disregard interbranch transactions, such as loans between a U.S. branch of the foreign corporation and its head office. Thus, whereas allocations using an arm’s-length standard permit adjustments to interbranch transactions only to the extent necessary to reflect economic substance and market pricing, the allocation formula under U.S. domestic tax laws wholly disregards such transactions without any inquiry into their substance or pricing. Although the allocation formula of U.S. domestic tax law clearly applies to foreign corporations from countries that do not have a tax treaty with the United States, the rules also provide that they apply to foreign corporations from countries that do have a tax treaty with the United States.

In published rulings, the Treasury Department has taken the position that the allocation formula under U.S. domestic tax law (including the disregard of interbranch transactions) is consistent with treaty provisions that govern the attribution of business profits to a U.S. permanent establishment of a foreign corporation that is resident in the other treaty country.⁴³ The Treasury Department has expressed the same view in the technical explanations of several recently negotiated treaties,⁴⁴ as well as the technical expla-

⁴¹The current OECD report on transfer pricing generally approves the methods that are incorporated in the current Treasury regulations under section 482 as consistent with the arm’s-length principles upon which Article 9 (Associated Enterprises) of the present and proposed treaties, and Article 7 (Business Profits) of the proposed treaty, are based. See OECD Committee on Fiscal Affairs, “Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators” (1995).

⁴²See Treas. Reg. sec. 1.882-5.

⁴³See Rev. Rul. 85-7, 1985-1 C.B. 188 (income tax treaty between the United States and Japan); Rev. Rul. 89-115, 1989-2 C.B. 130 (present treaty between the United States and the United Kingdom).

⁴⁴See, e.g., Technical Explanations of Tax Conventions with: The Republic of Austria, Treaty Doc. 104-31; The French Republic, Treaty Doc. 103-32; The Federal Republic of Germany, Treaty Doc. 101-10; Ireland, Treaty Doc. 105-31; The United Mexican States, Treaty Doc. 103-7; The Kingdom of The Netherlands, Treaty Doc. 103-6; The Portuguese Republic, Treaty Doc. 103-34; The Swiss Confederation, Treaty Doc. 105-8; The Kingdom of Thailand, Treaty Doc. 105-2; and The Republic of Turkey, Treaty Doc. 104-31.

nation of the U.S. model treaty. However, the position of the Treasury Department has been controversial and, in the case of the present treaty with the United Kingdom, recently has been rejected by the U.S. Court of Federal Claims, which concluded that the arm's-length standard mandated by the present treaty fundamentally conflicts with formula-based allocation and, in particular, the U.S. domestic tax laws that mandate an allocation formula and disregard any interbranch transactions.⁴⁵

Proposed treaty

Like the present treaty, the proposed treaty includes provisions that attribute the business profits of an enterprise to a permanent establishment on the basis of treating the permanent establishment as if it were independent from the enterprise of which it is a permanent establishment. The provisions in the proposed treaty concerning attribution of business profits to a permanent establishment generally are similar to provisions in the U.S. model and OECD model, except for additional language in the proposed treaty that further limits the attribution of business profits to a permanent establishment on the basis of risks assumed (as well as assets used and activities performed) by the permanent establishment. The proposed treaty also does not include a provision from the U.S. model and OECD model that would preclude the attribution of business profits to a permanent establishment that solely purchases goods or merchandise for the enterprise, apparently because this provision is inconsistent with the arm's-length standard.

The diplomatic notes state that the OECD Transfer Pricing Guidelines apply by analogy in determining the profits attributable to a permanent establishment. With respect to financial institutions (other than insurance companies), the diplomatic notes state that a treaty country may determine the amount of capital to be attributed to a permanent establishment by allocating the institution's total equity between (or among) its various offices on the basis of the proportion of the financial institution's risk-weighted assets attributable to each office.

Issues

Attribution of business profits generally

The provisions in the proposed treaty that attribute business profits to a permanent establishment present several issues. One issue concerns the continuing viability of U.S. domestic tax laws that require a formula-based allocation method for purposes of attributing business profits to a permanent establishment. The proposed treaty continues to apply the arm's-length standard on the basis of language that is substantially similar to the present treaty. In addition, the proposed treaty actually enhances the application of the arm's-length standard, for purposes of attributing business profits to a permanent establishment, by extending the OECD Transfer Pricing Guidelines and eliminating language that diverges from the arm's-length standard. However, the Technical Explanation does not indicate expressly whether the Treasury Depart-

⁴⁵*National Westminster Bank, PLC v. United States*, 44 Fed. Cl. 120 (1999); see also *North West Life Assurance Co. of Canada v. Commissioner*, 107 T.C. 363 (1996).

ment maintains its view that the interest expense allocation formula under U.S. domestic tax law is consistent with the arm's-length standard under the proposed treaty. Instead, the Technical Explanation appears to indicate that, to the extent the tax consequences of applying the allocation formula under U.S. domestic law diverges from the consequences of applying the arm's-length standard under the proposed treaty in determining the interest expense of a U.S. permanent establishment, U.K. residents with U.S. permanent establishments may effectively elect to apply either approach.

The Committee may wish to satisfy itself that it understands the current state of the Treasury Department position concerning the continuing viability of the interest expense allocation formula under U.S. domestic tax law within the context of the proposed treaty, as well as existing and future treaties.

Interbranch transactions

Another issue related to the interest expense allocation formula under U.S. domestic tax law concerns the treatment of interbranch transactions under the proposed treaty. As described above, U.S. domestic tax law provides that interbranch loans and other interbranch transactions are completely disregarded in determining the amount of interest expense deductions that are allowable against the U.S. taxable income of a foreign corporation. By contrast, the Technical Explanation indicates that interbranch transactions generally may be respected under the proposed treaty.

The OECD commentary for the OECD model provision upon which the proposed treaty is based provides that interbranch transactions generally are recognized in attributing business profits to a permanent establishment under arm's-length standards, except for "purely artificial arrangements". The OECD commentary does provide that interbranch transactions should be disregarded unless they constitute the types of transactions that the permanent establishment would have otherwise conducted with unrelated third parties in the normal course of their business. In this regard, the OECD commentary states that interbranch lending transactions and interest generally should be disregarded, although "special considerations" are to be given to recognizing interbranch lending transactions of financial institutions. As with formula-based allocations in general, the Treasury Department position that disregarding interbranch transactions altogether under U.S. domestic tax law is consistent with the arm's-length standard has been rejected in court with respect to interbranch lending transactions involving financial institutions.

The Committee may wish to satisfy itself that it understands the current state of the Treasury Department position concerning the continuing viability of disregarding interbranch transactions for purposes of the interest expense allocation formula under U.S. domestic tax law within the context of the proposed treaty, as well as existing and future treaties.

OECD interpretation of business profits attribution

Another issue concerns the currently evolving OECD interpretation of the provisions in the OECD model that provide for attrib-

uting business profits to a permanent establishment, which are substantially similar to the provisions in the proposed treaty for business profits attribution. In February 2001, the OECD published a discussion draft in which the OECD considered how to further integrate the arm's length standards of the 1995 OECD Transfer Pricing Guidelines into the business profits attribution provisions in the OECD model.⁴⁶ The OECD discussion draft is significant for purposes of the proposed treaty because the diplomatic notes state that the OECD Transfer Pricing Guidelines are to apply by analogy for purposes of determining the business profits that are attributable to a permanent establishment under the proposed treaty.

The OECD discussion draft generally attempts to outline a comprehensive approach that would apply the arm's-length standard under the OECD Transfer Pricing Guidelines to a permanent establishment in a manner similar to the current treatment of affiliated entities under the provisions of the OECD model concerning associated enterprises. However, it is clear from the OECD discussion draft that extending the OECD Transfer Pricing Guidelines to permanent establishments is problematic in several respects, and the OECD discussion draft expresses concern with respect to the lack of consensus among OECD members regarding the manner in which the arm's-length standard in the OECD Transfer Pricing Guidelines can accommodate the basic operational differences that exist between permanent establishments and affiliated entities. For example, the lack of documentation relating to interbranch transactions tends to be more prevalent than with respect to transactions between affiliated entities.

The OECD discussion draft devotes considerable attention to the application of the OECD Transfer Pricing Guidelines to bank branches and, in particular, the manner in which the arm's-length standard should take into account the financial risks assumed by a bank branch for purposes of allocating capital to the branch. For bank branches, the OECD discussion draft proposes a risk-based attribution of business profits using the 1988 capital measurement and capital adequacy standards set forth by the Basel Committee on Bank Supervision. The proposed treaty contemplates a similar risk-based approach by limiting the attribution of business profits to a permanent establishment on the basis of risks assumed (as well as assets used and activities performed) by the permanent establishment. However, attributing business profits to bank branches on the basis of non-tax regulatory standards is problematic for several reasons, including regulatory competition and arbitrage among regulatory jurisdictions.

Because the diplomatic notes adopt the OECD Transfer Pricing Guidelines with regard to attributing business profits to a permanent establishment, the proposed treaty is effectively committed to the outcome of the currently evolving and somewhat controversial interpretation of the arm's-length standard that was proposed in

⁴⁶ See OECD Committee on Fiscal Affairs, "Discussion Draft on the Attribution of Profits to Permanent Establishment" (2001). The OECD has indicated that it expects to release on March 4, 2003 a revised version of the discussion draft as it pertains to permanent establishments of banks. The OECD also has indicated that it expects to release in March 2003 a revised version of the discussion draft as it pertains to global trading of financial instruments.

the OECD discussion draft. The Committee may wish to consider the potential implications of the eventual OECD interpretation on the future application of the proposed treaty with regard to the attribution of business profits to a permanent establishment.

F. Income From the Rental of Ships and Aircraft

The proposed treaty includes a provision found in the U.S. model and many U.S. income tax treaties under which profits from an enterprise's operation of ships or aircraft in international traffic are taxable only in the enterprise's country of residence. This provision includes income from the rental of ships and aircraft on a full basis (*i.e.*, with crew) when such ships and aircraft are used in international traffic. However, in the case of profits derived from the rental of ships and aircraft on a bareboat basis (*i.e.*, without crew), the rule limiting the right to tax to the country of residence applies to such rental profits only if the rental income is incidental to other income of the lessor from the operation of ships and aircraft in international traffic. If the lease is not merely incidental to the international operation of ships and aircraft by the lessor, then profits from rentals on a bareboat basis generally would be taxable by the source country as business profits (if such profits are attributable to a permanent establishment).

In contrast, the U.S. model and many other treaties provide that profits from the rental of ships and aircraft operated in international traffic on a bareboat basis are taxable only in the country of residence, without requiring that the rental income be incidental to other profits of the lessor from the international operation of ships and aircraft. Thus, unlike the U.S. model, the proposed treaty provides that an enterprise that engages only in the *rental* of ships and aircraft on a bareboat basis, but does not engage in the *operation* of ships and aircraft, would not be eligible for the rule limiting the right to tax income from operations in international traffic to the enterprise's country of residence. It should be noted that, under the proposed treaty, profits from the use, maintenance, or rental of *containers* used in international traffic are taxable only in the country of residence, regardless of whether the recipient of such income is engaged in the operation of ships or aircraft in international traffic. The Committee may wish to consider whether the proposed treaty's rules treating profits from certain rentals of ships and aircraft on a bareboat basis less favorably than profits from the operation of ships and aircraft (or from the rental of ships and aircraft with crew) are appropriate.

G. Creditability of U.K. Petroleum Revenue Tax

Treatment under the proposed treaty

The proposed treaty extends coverage to the U.K. Petroleum Revenue Tax (paragraph 3(b)(iv) of Article 2 (Taxes Covered)). Article 24 of the proposed treaty (Relief from Double Taxation) further provides, among other things, that the U.K. Petroleum Revenue Tax is to be considered an income tax that is creditable against U.S. tax on income, subject to the provisions and limitations of that provision of the proposed treaty.

Specifically, the proposed treaty provides that the amount that the United States will allow as a credit against U.S. tax on income for U.K. Petroleum Revenue Taxes imposed on income from the extraction of minerals from oil or gas wells is limited to the amount attributable to U.K.-source taxable income. The proposed treaty further limits the creditable amount, however, to: (1) the product of the maximum statutory U.S. rate applicable to a corporation (i.e., 35 percent) and the amount of such extraction income; less (2) the amount of other U.K. taxes imposed on such extraction income. The proposed treaty provides that U.K. Petroleum Revenue Taxes from the extraction of minerals from oil or gas wells in excess of the above limitation may be used as a credit in the two preceding or five succeeding taxable years in accordance with the limitation described above. The proposed treaty further provides that its special rules on creditability apply separately and in the same way to the amount of U.K. Petroleum Revenue Tax imposed on income from the initial transportation, initial treatment, and initial storage of minerals from oil or gas wells in the United Kingdom.

To the extent that a taxpayer would obtain a more favorable result with respect to the creditability of the U.K. Petroleum Revenue Tax under the Code than under the proposed treaty, the taxpayer could choose not to rely on the proposed treaty.⁴⁷ The Technical Explanation to Article 24 of the proposed treaty states that if a person chooses in any year not to rely on the proposed treaty to claim a credit for U.K. Petroleum Revenue Taxes, then the special limitations under the proposed treaty would not apply for that year. Instead, the current overall foreign tax credit limitations of the Code would apply, and U.K. Petroleum Revenue Taxes creditable under the Code could be used, subject to the Code's limitations, to offset U.S. tax on other income from U.K. and other foreign sources.

Thus, the proposed treaty operates to create a separate "per country" limitation with respect to each U.S. category of extraction income, and initial transportation, treatment, and storage income on which U.K. Petroleum Revenue Tax is assessed. Accordingly, U.K. Petroleum Revenue Tax paid with respect to extraction income cannot be used as a credit to offset U.S. tax on: (1) oil and gas extraction income arising in another country; (2) U.K.-source transportation, treatment, or storage income on which U.K. Petroleum Revenue Tax is assessed; or (3) other U.K.-source non-oil related income.

U.K. internal law

The U.K. Petroleum Revenue Tax, introduced in 1975, is currently imposed at a rate of 50 percent on assessable profits from oil and gas extraction and certain other activities in the United Kingdom (including the North Sea) on a field-by-field basis. Under a separate Ring Fence Tax, oil and gas companies are required to segregate their income and expenses attributable to oil and gas related activities, and pay a separate corporate income tax for taxable income from unrelated activities. The U.K. Petroleum Revenue

⁴⁷ See paragraph 2 of Article 1 of the proposed treaty (General Scope), and accompanying description in the Technical Explanation.

Tax is imposed in addition to, and separate from, this Ring Fence Tax. The amount of U.K. Petroleum Revenue Tax paid is allowed as a deduction for purposes of computing the Ring Fence Tax. The U.K. Petroleum Revenue Tax applies to fields approved for development on or before March 15, 1993. Revenues from fields approved after March 15, 1993, are only subject to regular U.K. corporate income tax.

The U.K. Petroleum Revenue Tax is imposed on income relating to the extraction of oil and gas in the United Kingdom including such areas as the North Sea, income earned by taxpayers providing transportation, treatment, and other services relating to oil and gas resources in such areas, and income relating to the sale of such oil and gas related assets. With the exception of interest expense, most significant costs and expenses are currently deductible in determining taxable income. Operating losses may be carried back or forward without limit to income associated with a particular field.

Various other deductions and allowances are available against income assessed for these purposes, including: a supplemental uplift charge equal to 35 percent of most capital expenditures relating to a field; an oil allowance or exemption from the U.K. Petroleum Revenue Tax for each field up to a certain amount of metric tons of oil; a tariff receipts allowance for transportation receipts up to a certain amount, and certain non-field specific expenses such as research.

Issues

The proposed treaty treats the U.K. Petroleum Revenue Tax, and any substantially similar tax, as a creditable tax for U.S. foreign tax credit purposes. The United States Tax Court has recently addressed the creditability under the Code and the regulations under Code section 901 of the U.K. Petroleum Revenue Tax in the case of *Exxon v. Commissioner*.⁴⁸

In *Exxon v. Commissioner*, the United Kingdom granted licenses to Exxon for the exploitation of petroleum resources in the U.K.'s segment of the North Sea. Under those licenses, Exxon paid royalties, upfront fees, and annual fees. After the grant of the licenses, the U.K. enacted a modified version of the U.K. corporate income tax (the Ring Fence Tax) and the U.K. Petroleum Revenue Tax for oil production activities. The Tax Court considered whether the U.K. Petroleum Revenue Tax satisfied the net income requirement under the section 901 regulations and whether the U.K. Petroleum Revenue Tax was paid in exchange for a specific economic benefit (e.g., a royalty and not a tax). With respect to the net income issue, the court held that, notwithstanding the nondeductibility of interest expense in computing taxable income, the various allowances against the U.K. Petroleum Revenue Tax (particularly the 35 percent uplift charge which based on the Court's findings significantly exceeded interest expense) resulted in the predominant character of the tax being in the nature of an income or profits tax in the U.S. sense. With respect to the specific economic benefit issue, the court held that the U.K. Petroleum Revenue Tax paid for the years in question (1983–1988) constituted taxes and not payments for spe-

⁴⁸ 113 T.C. 338 (1999).

cific economic benefits. In so holding, the court relied on the fact that Exxon acquired its licenses to extract oil from the North Sea before the U.K. Petroleum Revenue Tax was enacted and that it received no new or additional benefits as a result of paying the U.K. Petroleum Revenue Tax.⁴⁹ The court thus found the U.K. Petroleum Revenue Tax paid by Exxon to be creditable under U.S. law.

The Internal Revenue Service acquiesced in the *Exxon* decision, but only as to its results.⁵⁰ The Internal Revenue Service indicated in its acquiescence that it will only follow the opinion in disposing of cases involving the U.K. Petroleum Revenue Tax where the facts are substantially similar to those in the *Exxon* case. Since such determinations are inherently factual, the determination of the creditability of the U.K. Petroleum Revenue Tax under U.S. law as a general matter is unclear.

If the U.K. Petroleum Revenue Tax would generally be considered creditable under the Code, then there may be a question as to the need for the additional limitations provided under the proposed treaty for determining the amount of creditable U.K. Petroleum Revenue Tax. Taxpayers are likely to rely on the proposed treaty only to the extent that it provides them with a more favorable foreign tax credit result than would otherwise result from the application of the Code. In addition, since the U.K. Petroleum Revenue Tax has been eliminated with respect to fields approved after March 15, 1993, it is unclear to what extent these creditability issues will remain important in future years.

On the other hand, to the extent that it is unclear whether the U.K. Petroleum Revenue Tax is generally considered to be creditable under U.S. law, the primary issue is the extent to which treaties should be used to provide a credit for taxes that may not otherwise be fully creditable and, in cases where a treaty does provide creditability, to what extent the treaty should impose limitations not contained in the Code. A related issue is whether a controversial matter in U.S. tax policy such as the tax credits to be allowed U.S. oil companies on their foreign extraction operations should be resolved through the treaty process rather than through the normal legislative process.

Similar provisions making Denmark's Hydrocarbon Tax, Norway's Submarine Petroleum Resource Tax, and the Netherlands's Profit Share creditable are contained in the U.S.-Denmark income tax treaty, the protocol to the U.S.-Norway income tax treaty, and the U.S.-Netherlands income tax treaty, respectively. Also at issue, therefore, is whether the United Kingdom should be denied a special treaty credit for taxes on oil and gas extraction income when Denmark, Norway, and the Netherlands, its North Sea competitors, now receive a similar treaty credit under the U.S. income tax treaties with those countries currently in force. On the one hand, it would appear fair to treat the United Kingdom like Denmark, Norway, and the Netherlands. On the other hand, the United States

⁴⁹The Court further based its holding that Exxon did not pay the U.K. Petroleum Revenue Tax in exchange for specific economic benefits based on the following: (1) the royalties and other fees paid by Exxon represented substantial and reasonable compensation, (2) the U.K.'s purposes in enacting the U.K. Petroleum Revenue Tax was to take advantage of increases in oil prices and to assure itself of a share of those excess profits, and (3) the U.K. Petroleum Revenue Tax had all of the characteristics of a tax and was intended to be a tax.

⁵⁰2001-31 I.R.B. 98 (August 20, 2001).

should not view any particular treaty concession to one country as requiring identical or similar concessions to other countries.

The present treaty contains a similar provision providing for the creditability of the U.K. Petroleum Revenue Tax. During Senate consideration of the third protocol to the present treaty, a reservation was proposed to apply similar per-country limitations to prevent U.S. oil companies from using the U.K. Petroleum Revenue Tax as a credit against their U.S. tax liability on extraction income from other countries.⁵¹ The reservation was withdrawn and the per-country limitations were included in that protocol to the present treaty.

The Committee may wish to satisfy itself as to whether, to the extent that the creditability of the U.K. Petroleum Revenue Tax is unclear under U.S. law, the proposed treaty is an appropriate vehicle for granting such creditability.

H. Teachers, Students, and Trainees

Treatment under proposed treaty

General rule

The proposed treaty generally would not change the application of income taxes to certain individuals who visit the United States or United Kingdom as students, teachers, academic researchers, or so-called “business apprentices” engaged in full-time training. The present treaty (Article 20) provides that a professor or teacher who visits the United States from the United Kingdom or the United Kingdom from the United States for a period of two years or less to engage in teaching or research at a university or college is exempt from tax by the host country on any remuneration received for such teaching or research. In addition, the present treaty (Article 21) provides that certain payments that a student or business apprentice who visits the United States from the United Kingdom or the United Kingdom from the United States to pursue full-time education at a university or college or to engage in full-time training are exempt from taxation by the host country. The exempt payments are limited to those payments the individual may receive for his or her maintenance, education or training as long as such payments are from sources outside the host country.

Under Article 20 of the proposed treaty, U.S. taxpayers who are visiting the United Kingdom and individuals who immediately prior to visiting the United States was resident in the United Kingdom will be exempt from income tax in the host country on certain payments received if the purpose of their visit is to engage in full-time education at a university or college or to engage in full-time training. The exempt payments are limited to those payments the individual may receive for his or her maintenance, education or training as long as such payments are from sources outside the host country. In the case of individuals engaged in full-time training, the exemption from income tax in the host country applies only for a period of one year or less.

⁵¹The text of the proposed reservation is reprinted at 124 Cong. Rec. S9559 (daily ed., June 27, 1978).

Under Article 20A of the proposed treaty, U.S. taxpayers who are visiting the United Kingdom and individuals who immediately prior to visiting the United States was resident in the United Kingdom will be exempt from income tax in the host country on remuneration they receive for teaching or research at a university, college, or other recognized educational institution. The exemption is limited to visiting periods of two years or less.

Transition rule

Under the entry in force provisions of the proposed treaty (Article 29), taxpayers may elect temporarily to continue to claim benefits under the present treaty with respect to a period after the proposed treaty takes effect. For an individual engaged in full-time training, Article 21 of the present treaty would continue to have effect in its entirety until such time as the individual had completed his or her training. For some individuals this special rule may provide benefits under the present treaty that exceed those available under the general transition rule. The general transition rule would provide that an individual would have the benefits of the present treaty for twelve months from the date on which the proposed treaty comes into force.

Issues

General rule

Teachers and professors.—Unlike the U.S. model, but like the present treaty, the proposed treaty would provide an exemption from the host country income tax for income an individual receives from teaching or research in the host country. Prior to amendment by the protocol, the proposed treaty would have followed the U.S. model and no such exemption would have been provided. Article 20 of the present treaty and Article 20A of the proposed treaty provide that a teacher who visits a country for the purpose of teaching or engaging in research at a recognized educational institution generally is exempt from tax in that country for a period not exceeding two years. Under the proposed treaty, a U.S. person who is a teacher or professor may receive effectively an exemption from any income tax for income earned related to visiting the United Kingdom for the purpose of engaging in teaching or research for a period of two years or less. Under the terms of the treaty, the United Kingdom would exempt any such income of a U.S. person from U.K. income tax. Under Code sec. 911, \$80,000 would be exempt from U.S. income tax in 2003 through 2007,⁵² and in addition certain living expenses would be deductible from income. To the extent the U.S. teacher's or professor's remuneration related to his or her visit to the United Kingdom was less than \$80,000, the income would be tax free. Likewise, under the proposed treaty, a U.K. person who is a teacher or professor may receive effectively an exemption from any income tax for income earned related to visiting the United States for the purpose of engaging in teaching or research for a period of two years or less. Under the terms of the treaty, the United States would exempt any such income from U.S. income tax. Under

⁵²For years after 2007, the \$80,000 amount is indexed for inflation after 2006 (Code sec. 911(b)(2)(D)).

the terms of U.K. tax law, such income generally would not be taxable by the U.K. as the individual would not be resident in the United Kingdom.

The effect of the proposed treaty is to make such cross-border visits more attractive financially. Ignoring relocation expenses, a U.S. citizen or permanent resident may receive more net, after-tax remuneration from teaching or research from visiting the United Kingdom as a teacher or researcher than if he or she had remained in the United States. Likewise a U.K. resident may receive more net, after-tax remuneration from teaching or research from visiting the United States as a teacher or researcher than if he or she had remained in the United Kingdom. Increasing the financial reward may serve to encourage cross-border visits by academics. Such cross-border visits by academics for teaching and research may foster the advancement of knowledge and redound to the benefit of residents of both countries.

On the other hand, complete exemption from income tax in both the United States and the United Kingdom may be seen as unfair when compared to persons engaged in other occupations whose occupation or employment may cause them to relocate temporarily abroad. For a U.S. citizen or permanent resident who is not a teacher or professor, but who temporarily takes up residence and employment in the United Kingdom, his or her income is subject to income tax in the United Kingdom and may be subject income tax in the United States. Likewise, for a U.K. resident who is not a teacher or professor, but who temporarily takes up residence and employment in the United States, his or her income is subject to income tax in the United States. In other words, the proposed treaty could be said to violate the principle of horizontal equity by treating otherwise similarly economically situated taxpayers differently.

The proposed treaty reverses the position of the originally proposed treaty with respect to visiting teachers and professors. Prior to amendment by the protocol, the proposed treaty would have followed the U.S. model and no such exemption would have been provided. While this is the position of the U.S. model, an exemption for visiting teachers and professors has been included in many bilateral tax treaties. Of the more than 50 bilateral income tax treaties in force, 30 include provisions exempting from host country taxation the income of a visiting individual engaged in teaching or research at an educational institution, and an additional 10 treaties provide a more limited exemption from taxation in the host country for a visiting individual engaged in research. Although the proposed protocols with Australia and Mexico would not include similar provisions, three of the most recently ratified income tax treaties did contain such a provision.⁵³

The Committee may wish to satisfy itself that the inclusion of such an exemption for a limited class of individuals is appropriate. Looking beyond the U.S.-U.K. treaty relationship, the Committee

⁵³The treaties with Italy, Slovenia, and Venezuela, each considered in 1999, contain provisions exempting the remuneration of visiting teachers and professors from host country income taxation. The treaties with Denmark, Estonia, Latvia, and Lithuania, also considered in 1999, did not contain such an exemption, but did contain a more limited exemption for visiting researchers.

may wish to determine whether the inclusion of the exemption from host country taxation for visiting teachers and professors signals a broader shift in U.S. tax treaty policy. Specifically, the Committee may want to know whether the Treasury Department intends to pursue similar provisions in other proposed treaties in the future and intends to amend the U.S. model to reflect such a development.⁵⁴

Full-time students and persons engaged in full-time training.—The present treaty has no limitation on the duration of such training. As was the case for teachers and professors, described above, the proposed treaty generally has the effect of exempting payments received for the maintenance, education, and training of full-time students and persons engaged in full-time training as a visitor from the United States to the United Kingdom or as a visitor from the United Kingdom to the United States from the income tax of both the United States and the United Kingdom. This conforms to the U.S. model and OECD model provisions with respect to students and trainees.

This provision generally would have the effect of reducing the cost of such education and training received by visitors. The proposed treaty would narrow the exemption provided under the current treaty to persons who are engaged in full-time training by limiting the exemption in the case of a business apprentice to payments made relating to training received during a period of one year or less. (The exemption for full-time students remains unchanged from the current treaty.) By potentially subjecting such payments to host country income tax, the cost for cross-border visitors of engaging in such longer duration training programs would be increased. This may discourage visitors to such programs in both the United States and the United Kingdom. It could be argued that the training of a business apprentice relates primarily to specific job skills of value to the individual or the individual's employer rather than enhancing general knowledge and cross-border understanding, as may be the case in the university or college education of a full-time student. This could provide a rationale for providing more open-ended treaty benefits in the case of students as opposed to business apprentices. However, if this provides the underlying rationale, a question might arise as to why training requiring one year or less is preferred to training that requires a longer visit to the host country. As such, the proposed treaty would favor certain types of training arrangements over others.

Transition rule

The primary issue is the extent to which a special transition rule should be included in U.S. tax treaties. It is the staff's understanding that there is not a similar precedent for such a special transition rule in other U.S. tax treaties. The proposed treaty con-

⁵⁴ More broadly, since the U.S. model has not been updated since 1996, the Committee may wish to ask whether the Treasury Department intends to update the model to reflect all relevant developments that have occurred in the intervening years. A thoroughly updated model would provide a more meaningful and useful guide to current U.S. tax treaty policy and would thereby increase transparency and facilitate congressional oversight in this important area. See, *Recommendations for Simplification, Pursuant to Section 8002(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01), April 2001, Vol. II, at 445-47 (recommending that the Treasury Department revise U.S. model tax treaties once per congress).

tains a general grandfather provision that would allow taxpayers, including trainees, to continue to apply the provisions of the present treaty for one year. It could be argued that the general grandfather provision sufficiently addresses the transition of all taxpayers into the proposed treaty. It also could be argued that the special transition rule for trainees results in disparate treatment for other taxpayers that do not get the benefit of similar transition rules for other provisions of the proposed treaty. It further could be argued that this rule may be viewed as a precedent to provide similar or possibly even broader transition relief with respect to future revisions of existing treaties for benefits that may not be viewed as appropriate or consistent with current U.S. treaty policy or are otherwise viewed as inconsistent with the purposes of an income tax treaty.

On the other hand, the special transition rule presumably was included to provide relief for trainees who may have based their decisions to begin training upon the assumption that the relevant provisions of the present treaty would apply to them. The general one-year grandfather provision may not provide complete relief for such individuals. There also may be a general expectation among taxpayers that subsequently renegotiated tax treaties generally do not restrict benefits contained in existing treaties, but instead often provide further benefits. It could be argued that these special transition rules apply to a limited class of taxpayers and only for a limited period of time beyond the general grandfather period.

The Committee may wish to satisfy itself as to the appropriateness of including a special transition rule such as that described above in U.S. tax treaties.

