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TAX CONVENTION WITH SWITZERLAND

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Mr. HELMS, from the Committee on Foreign Relations, submitted the following

REPORT

[To accompany Treaty Doc. 105–8]

The Committee on Foreign Relations, to which was referred the Convention between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income, signed at Washington, October 2, 1996, together with a Protocol to the Convention, having considered the same, reports favorably thereon, with two declarations and one proviso, and recommends that the Senate give its advice and consent to ratification thereof, as set forth in this report and the accompanying resolution of ratification.

CONTENTS

I. PURPOSE

The principal purposes of the proposed income tax treaty between the United States and the Swiss Confederation ("Switzerland") 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 income taxes of the two countries. The proposed treaty is intended to continue 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. It is intended to

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enable the two countries to cooperate in preventing avoidance and evasion of taxes.

II. BACKGROUND

The proposed treaty and proposed protocol both were signed on October 2, 1996. The United States and Switzerland also exchanged notes with an attached Memorandum of Understanding to provide clarification with respect to the application of the proposed treaty.[1] The proposed treaty would replace the existing income tax treaty between the two countries that was signed in 1951.

The proposed treaty, together with the proposed protocol, was transmitted to the Senate for advice and consent to its ratification on June 25, 1997 (see Treaty Doc. 105–8). The Senate Committee on Foreign Relations held a public hearing on the proposed treaty and proposed protocol on October 7, 1997.

III. SUMMARY

The proposed treaty (as supplemented by the proposed protocol) is similar to other recent U.S. income tax treaties, the 1996 U.S. model income tax treaty ("U.S. model"),[2] and the model income tax treaty of the Organization for Economic Cooperation and Development ("OECD model"). However, the proposed treaty and proposed protocol contain certain substantive deviations from those documents.

As in other U.S. tax treaties, the proposed treaty's objective of reducing or eliminating double taxation principally is achieved by each country agreeing 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 neither country generally will 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 or fixed base (Articles 7 and 14). Similarly, the 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, 15, and 17). The proposed treaty provides that dividends and certain capital gains derived by a resident of either country from sources within the other country may be taxed by both countries (Articles 10 and 13); however, the rate of tax that the source-country may impose on a resident of the other country on dividends generally will be limited by the proposed treaty (Article 10). The proposed treaty also provides that interest and royalties derived by a resident of either country generally will be exempt from tax in the other country (Articles 11, 12 and 21).

[1] The United States and Switzerland originally exchanged notes dated October 2, 1996, with an attached Memorandum of Understanding. The United States and Switzerland subsequently exchanged notes, dated April 8, 1997, and May 14, 1997. Attached to those subsequent notes was a revised Memorandum of Understanding (which is included in Treaty Doc. 105–8). (The notes dated April 8, 1997, and May 14, 1997, are reproduced in the Appendix to this report.)

[2] The Treasury Department released the U.S. model on September 20, 1996. A 1981 U.S. model treaty was withdrawn by the Treasury Department on July 17, 1992.

In situations where the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the 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 23).

The proposed treaty contains the standard provision (the "saving clause") contained in U.S. tax treaties that each country retains the right to tax its citizens and residents as if the treaty had not come into effect (Article 1). In addition, the proposed treaty contains the standard provision that it may not be applied to deny any taxpayer any benefits the taxpayer would be entitled to under the domestic law of a country or under any other agreement between the two countries (Article 28).

The proposed treaty also contains a detailed limitation on benefits provision to prevent the inappropriate use of the treaty by third-country residents (Article 22).

IV. Entry Into Force and Termination

A. ENTRY INTO FORCE

The proposed treaty is subject to ratification in accordance with the applicable procedures of each country, and instruments of ratification are to be exchanged as soon as possible. In general, the proposed treaty will enter into force upon the exchange of instruments of ratification. The present treaty generally ceases to have effect once the provisions of the proposed treaty take effect.

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

Where greater benefits would be available to a taxpayer under the present treaty than under the proposed treaty, the proposed treaty provides that the taxpayer may elect to be taxed under the present treaty (in its entirety) for the twelve-month period beginning on the date the proposed treaty would otherwise have effect.

B. TERMINATION

The proposed treaty will continue in force until terminated by either country. Either country may terminate the proposed treaty at any time by giving at least six months prior notice through diplomatic channels. A termination will be effective with respect to taxes withheld at source for amounts paid or credited on or after the first of January following the expiration of the six-month period. A termination will be effective with respect to other taxes for taxable periods beginning on or after the first of January following the expiration of the six-month period.

V. Committee Action

The Committee on Foreign Relations held a public hearing on the proposed treaty with Switzerland and the related protocol (Treaty Doc. 105–8), as well as on other proposed tax treaties and protocols, on October 7, 1997. The hearing was chaired by Senator Hagel. The Committee considered these proposed treaties and protocols on October 8, 1997, and ordered the proposed treaty with Switzerland and the related protocol favorably reported by voice vote, with the recommendation that the Senate give its advice and consent to ratification of the proposed treaty and proposed protocol, subject to two declarations and a proviso.

VI. Committee Comments

On balance, the Committee on Foreign Relations believes that the proposed treaty with Switzerland is in the interest of the United States and urges that the Senate act promptly to give advice and consent to ratification. However, the Committee has taken note of certain issues raised by the proposed treaty and believes that the following comments may be useful to Treasury Department officials in providing guidance on these matters should they arise in the course of future treaty negotiations.

A. TREATMENT OF REIT DIVIDENDS

REITs in general

Real Estate Investment Trusts ("REITs") essentially are treated as conduits for U.S. tax purposes. The income of a REIT generally is not taxed at the entity level but is distributed and taxed only at the investor level. This single level of tax on REIT income is in contrast to other corporations, the income of which is subject to tax at the corporate level and is taxed again at the shareholder level upon distribution as a dividend. Hence, a REIT is like a mutual fund that invests in qualified real estate assets.

An entity that qualifies as a REIT is taxable as a corporation. However, unlike other corporations, a REIT is allowed a deduction for dividends paid to its shareholders. Accordingly, income that is distributed by a REIT to its shareholders is not subject to corporate tax at the REIT level. A REIT is subject to corporate tax only on any income that it does not distribute currently to its shareholders. As discussed below, a REIT is required to distribute on a current basis the bulk of its income each year.

In order to qualify as a REIT, an entity must satisfy, on a year-by-year basis, specific requirements with respect to its organizational structure, the nature of its assets, the source of its income, and the distribution of its income. These requirements are intended to ensure that the benefits of REIT status are accorded only to pooling of investment arrangements, the income of which is derived from passive investments in real estate and is distributed to the investors on a current basis.

In order to satisfy the organizational structure requirements for REIT status, a REIT must have at least 100 shareholders and not more than 50 percent (by value) of its shares may be owned by five or fewer individuals. In addition, shares of a REIT must be transferrable.

In order to satisfy the asset requirements for REIT status, a REIT must have at least 75 percent of the value of its assets invested in real estate, cash and cash items, and government securities. In addition, diversification rules apply to the REIT's investment in assets other than the foregoing qualifying assets. Under these rules, not more than 5 percent of the value of its assets may be invested in securities of a single issuer and any such securities held may not represent more than 10 percent of the voting securities of the issuer.

In order to satisfy the source of income requirements, at least 95 percent of the gross income of the REIT generally must be from certain passive sources (e.g., dividends, interest, and rents). In addition, at least 75 percent of its gross income generally must be from certain real estate sources (e.g., real property rents, mortgage interest, and real property gains).

Finally, in order to satisfy the distribution of income requirement, the REIT generally is required to distribute to its shareholders each year at least 95 percent of its taxable income for the year (excluding net capital gains). A REIT may retain 5 percent or less of its taxable income and all or part of its net capital gain.

A REIT is subject to corporate-level tax only on any taxable income and net capital gains that the REIT retains. Under an available election, shareholders may be taxed currently on the undistributed capital gains of a REIT, with the shareholder entitled to a credit for the tax paid by the REIT with respect to the undistributed capital gains such that the gains are subject only to a single level of tax. Distributions from a REIT of ordinary income are taxable to the shareholders as a dividend, in the same manner as dividends from an ordinary corporation. Accordingly, such dividends are subject to tax at a maximum rate of 39.6 percent in the case of individuals and 35 percent in the case of corporations. In addition, capital gains of a REIT distributed as a capital gain dividend are taxable to the shareholders as capital gain. Capital gain dividends received by an individual will be eligible for preferential capital gain tax rates if the relevant holding period requirements are satisfied.

Foreign investors in REITs

Nonresident alien individuals and foreign corporations (collectively, foreign persons) are subject to U.S. tax on income that is effectively connected with the foreign person's conduct of a trade or business in the United States, in the same manner and at the same graduated tax rates as U.S. persons. In addition, foreign persons generally are subject to U.S. tax at a flat 30-percent rate on certain gross income that is derived from U.S. sources and that is not effectively connected with a U.S. trade or business. The 30-percent tax applies on a gross basis to U.S.-source interest, dividends, rents, royalties, and other similar types of income. This tax generally is collected by means of withholding by the person making the payment of such amounts to a foreign person.

Capital gains of a nonresident alien individual that are not connected with a U.S. business generally are subject to the 30-percent withholding tax only if the individual is present in the United States for 183 days or more during the year. The United States generally does not tax foreign corporations on capital gains that are not connected with a U.S. trade or business. However, foreign persons generally are subject to U.S. tax on any gain from a disposition of an interest in U.S. real property at the same rates that apply to similar income received by U.S. persons. Therefore, a foreign person that has capital gains with respect to U.S. real estate is subject to U.S. tax on such gains in the same manner as a U.S. person. For this purpose, a distribution by a REIT to a foreign shareholder that is attributable to gain from a disposition of U.S. real property by the REIT is treated as gain recognized by such shareholder from the disposition of U.S. real property.

U.S. income tax treaties contain provisions limiting the amount of income tax that may be imposed by one country on residents of the other country. Many treaties, like the proposed treaty, generally allow the source-country to impose not more than a 15-percent withholding tax on dividends paid to a resident of the other treaty country. In the case of real estate income, most treaties, like the proposed treaty, specify that income derived from, and gain from dispositions of, real property in one country may be taxed by the country in which the real property is situated without limitation.[3] Accordingly, U.S. real property rental income derived by a resident of a treaty partner generally is subject to the U.S. withholding tax at the full 30-percent rate (unless the net-basis taxation election is made), and U.S. real property gains of a treaty partner resident are subject to U.S. tax in the manner and at the rates applicable to U.S. persons.

Although REITs are not subject to corporate-level taxation like other corporations, distributions of a REIT's income to its shareholders generally are treated as dividends in the same manner as distributions from other corporations. Accordingly, in cases where no treaty is applicable, a foreign shareholder of a REIT is subject to the U.S. 30-percent withholding tax on ordinary income distributions from the REIT. In addition, such shareholders are subject to U.S. tax on U.S. real estate capital gain distributions from a REIT in the same manner as a U.S. person.

In cases where a treaty is applicable, this U.S. tax on capital gain distributions from a REIT still applies. However, absent special rules applicable to REIT dividends, treaty provisions specifying reduced rates of tax on dividends apply to ordinary income dividends from REITs as well as to dividends from taxable corporations. As discussed above, the proposed treaty, like many U.S. treaties, reduces the U.S. 30-percent withholding tax to 15 percent in the case of dividends generally. Prior to 1989, U.S. tax treaties contained no special rules excluding dividends from REITs from these reduced rates. Therefore, under pre-1989 treaties such as the present treaty with Switzerland, REIT dividends are eligible for the same reductions in the U.S. withholding tax that apply to other corporate dividends.

Beginning in 1989, U.S. treaty negotiators began including in treaties provisions excluding REIT dividends from the reduced rates of withholding tax generally applicable to dividends. Under treaties with these provisions such as the proposed treaty, REIT

[3] The proposed treaty, like many treaties, allows the foreign person to elect to be taxed in the source-country on income derived from real property on a net basis under the source country's domestic laws.

dividends generally are subject to the full U.S. 30-percent withholding tax.[4]

Analysis of treaty treatment of REIT dividends

The specific treaty provisions governing REIT dividends were introduced beginning in 1989 because of concerns that the reductions in withholding tax generally applicable to dividends were inappropriate in the case of dividends from REITs. The reductions in the rates of source-country tax on dividends reflect the view that the full 30-percent withholding tax rate may represent an excessive rate of source-country taxation where the source-country already has imposed a corporate-level tax on the income prior to its distribution to the shareholders in the form of a dividend. In the case of dividends from a REIT, however, the income generally is not subject to corporate-level taxation.

REITs are required to distribute their income to their shareholders on a current basis. The assets of a REIT consist primarily of passive real estate investments and the REIT's income may consist principally of rentals from such real estate holdings. U.S. source rental income generally is subject to the U.S. 30-percent withholding tax. Moreover, the United States's treaty policy is to preserve its right to tax real property income derived from the United States. Accordingly, the U.S. 30-percent tax on rental income from U.S. real property is not reduced in U.S. tax treaties.

If a foreign investor in a REIT were instead to invest in U.S. real estate directly, the foreign investor would be subject to the full 30-percent withholding tax on rental income earned on such property (unless the net-basis taxation election is made). However, when the investor makes such investment through a REIT instead of directly, the income earned by the investor is treated as dividend income. If the reduced rates of withholding tax for dividends apply to REIT dividends, the foreign investor in the REIT is accorded a reduction in U.S. withholding tax that is not available for direct investments in real estate.

On the other hand, some argue that it is important to encourage foreign investment in U.S. real estate through REITs. In this regard, a higher withholding tax on REIT dividends (i.e., 30 percent instead of 15 percent) may not be fully creditable in the foreign investor's home country and the cost of the higher withholding tax therefore may discourage foreign investment in REITs. For this reason, some oppose the inclusion in U.S. treaties of the special provisions governing REIT dividends, arguing that dividends from REITs should be given the same treatment as dividends from other corporate entities. Accordingly, under this view, the 15-percent withholding tax rate generally applicable under treaties to dividends should apply to REIT dividends as well.

This argument is premised on the view that investment in a REIT is not equivalent to direct investment in real property. From this perspective, an investment in a REIT should be viewed as comparable to other investments in corporate stock. In this regard, like other corporate shareholders, REIT investors are investing in

[4] Many treaties, like the proposed treaty, provide a maximum tax rate of 15 percent in the case of REIT dividends beneficially owned by an individual who holds a less than 10 percent interest in the REIT.

the management of the REIT and not just its underlying assets. Moreover, because the interests in a REIT are widely held and the REIT itself typically holds a large and diversified asset portfolio, an investment in a REIT represents a very small investment in each of a large number of properties. Thus, the REIT investment provides diversification and risk reduction that are not easily replicated through direct investment in real estate.

At the October 7, 1997 hearing on the proposed treaty (as well as other proposed treaties and protocols), the Treasury Department announced that it has modified its policy with respect to the exclusion of REIT dividends from the reduced withholding tax rates applicable to other dividends under treaties. The Treasury Department worked extensively with the staff of the Committee on Foreign Relations, the staff of the Joint Committee on Taxation, and representatives of the REIT industry in order to address the concern that the current treaty policy with respect to REIT dividends may discourage some foreign investment in REITs while maintaining a treaty policy that properly preserves the U.S. taxing jurisdiction over foreign direct investment in U.S. real property. The new policy is a result of significant cooperation among all parties to balance these competing considerations.

Under this policy, REIT dividends paid to a resident of a treaty country will be eligible for the reduced rate of withholding tax applicable to portfolio dividends (typically, 15 percent) in two cases. First, the reduced withholding tax rate will apply to REIT dividends if the treaty country resident beneficially holds an interest of 5 percent or less in each class of the REIT's stock and such dividends are paid with respect to a class of the REIT's stock that is publicly traded. Second, the reduced withholding tax rate will apply to REIT dividends if the treaty country resident beneficially holds an interest of 10 percent or less in the REIT and the REIT is diversified, regardless of whether the REIT's stock is publicly traded. In addition, the current treaty policy with respect to the application of the reduced withholding tax rate to REIT dividends paid to individuals holding less than a specified interest in the REIT will remain unchanged.

For purposes of these rules, a REIT will be considered diversified if the value of no single interest in real property held by the REIT exceeds 10 percent of the value of the REIT's total interests in real property. An interest in real property will not include a mortgage, unless the mortgage has substantial equity components. An interest in real property also will not include foreclosure property. Accordingly, a REIT that holds exclusively mortgages will be considered to be diversified. The diversification rule will be applied by looking through a partnership interest held by a REIT to the underlying interests in real property held by the partnership. Finally, the reduced withholding tax rate will apply to a REIT dividend if the REIT's trustees or directors make a good faith determination that the diversification requirement is satisfied as of the date the dividend is declared.

The Treasury Department will incorporate this new policy with respect to the treatment of REIT dividends in the U.S. model treaty and in future treaty negotiations. In addition, the Treasury Department has committed to use its best efforts to negotiate a protocol with Switzerland to amend the proposed treaty to incorporate this policy.

The Committee believes that the new policy with respect to the applicability of reduced withholding tax rates to REIT dividends appropriately reflects economic changes since the establishment of the current policy. The Committee further believes that the new policy fairly balances competing considerations by extending the reduced rate of withholding tax on dividends generally to dividends paid by REITs that are relatively widely-held and diversified. The Committee encourages the Treasury Department to act expeditiously in meeting its commitment to negotiate a protocol with Switzerland that incorporates this new policy.

B. EXCHANGE OF INFORMATION

One of the principal purposes of the proposed income tax treaty between the United States and Switzerland is to prevent avoidance or evasion of income taxes of the two countries. The exchange of information article of the proposed treaty is one of the primary vehicles used to achieve that purpose.

The exchange of information article contained in the proposed treaty conforms in some respects to and deviates significantly in other respects from the corresponding articles of the U.S. and OECD models. As is true under these model treaties and the present treaty, under the proposed treaty a country is not required to carry out administrative measures at variance with the laws and administrative practices of either country, to supply information which is not obtainable under the laws or in the normal course of the administration of either country, or to supply information which discloses any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which is contrary to public policy.

The proposed treaty deviates significantly from the corresponding articles of the U.S. and OECD models in the scope of the information exchange provision. Under the proposed treaty, information shall be exchanged as is necessary to carry out the purposes of the proposed treaty or for the prevention of tax fraud. The proposed treaty does not permit the exchange of information to carry out the provisions of domestic law of the parties to the treaty; such a provision is included in the corresponding articles of both the U.S. and OECD models. The omission of this provision means that under the proposed treaty, exchange of information will not be possible for the purpose of routine enforcement of the tax laws (except as is necessary to carry out the purposes of the proposed treaty or for the prevention of tax fraud). Consequently, the information exchange provision in the proposed treaty is significantly more restrictive than the corresponding provisions in either the model treaties or most other tax treaties into which the United States has entered in recent years.

The proposed treaty does contain several provisions relating to exchanges of information for the prevention of tax fraud that are somewhat broader than the corresponding provision in the present treaty. First, the proposed treaty provides that the exchange of information is not restricted by the personal scope provisions of the proposed treaty. Consequently, information exchanges may occur with respect to persons otherwise outside the scope of the proposed treaty. There is no comparable provision in the present treaty. Second, the proposed treaty explicitly provides that authenticated copies of unedited original records or documents shall be provided when requested. The Treasury Department's Technical Explanation of the proposed treaty (hereinafter referred to as the "Technical Explanation") states that the Swiss Supreme Court, in interpreting the present treaty, limited the form in which information could be provided to reports and summaries of information. Third, the Memorandum of Understanding states that in cases of tax fraud, Swiss banking secrecy provisions do not hinder the gathering of documentary evidence from banks or its being provided to the United States pursuant to the proposed treaty.

As part of its consideration of the proposed treaty, the Committee asked if the Treasury Department considers the exchange of information provisions of the proposed treaty to be sufficient to carry out the tax-avoidance purposes for which income tax treaties are entered into by the United States. The relevant portion of the Treasury Department's October 8, 1997 letter[5] responding to this inquiry is reproduced below:

> Although the exchange of information provisions of the proposed treaty are not as broad as the U.S. Model provisions, they represent a significant improvement over those in the present treaty. . . . [T]he new treaty and Protocol contain a clear, broad definition of "tax fraud" that should lead to improved information exchange. The new treaty also provides that information will, where possible, be provided in a form that will make it possible for the information to be used in court proceedings. While these measures do not go as far as we would like, the improvement that they will allow in our exchange of information program with Switzerland should make the anti-avoidance provisions of the new treaty far more effective than under the present treaty.

In addition, the Treasury Department noted both the constraints imposed by Swiss law on reaching a theoretically more desirable information exchange provision and the fact that the information exchange provision of the proposed treaty is more expansive than those of any other Swiss treaty.

Although broader exchange of information provisions are desirable, the Committee understands the difficulty in achieving broader provisions given the constraints of Swiss law. Additionally, the Committee notes that the exchange of information provisions of the proposed treaty are somewhat improved over the comparable provisions of the present treaty. However, the Committee does not believe that the proposed Swiss treaty should be construed in any way as a precedent for other negotiations. The exchange of information provisions in treaties are central to the purposes for which tax treaties are entered into, and significant limitations on their effect, relative to the preferred U.S. tax treaty position, should not be accepted in negotiations with other countries that seek to have or to maintain the benefits of a tax treaty relationship with the United States.

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[5] Letter from Joseph H. Guttentag, International Tax Counsel, Treasury Department, to Senator Paul Sarbanes, Committee on Foreign Relations, October 8, 1997 ("October 8, 1997 Treasury Department letter").

C. INSURANCE EXCISE TAX

The proposed treaty, unlike the present treaty, covers the U.S. excise tax on insurance premiums paid to foreign insurers. With the waiver of the excise tax on insurance premiums, for example, a Swiss insurer without a permanent establishment in the United States can collect premiums on policies covering a U.S. risk or a U.S. person free of the excise tax on insurance premiums. However, the tax is imposed to the extent that the risk is reinsured by the Swiss insurer with a person not entitled to the benefits of an income tax treaty providing exemption from the tax. This latter rule is known as the "anti-conduit" clause.

Such waivers of the excise tax 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, if the risk is reinsured, the reinsurer). 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 granted by Treasury in its future treaty negotiations without prior consultations with the appropriate committees of Congress.[6] Congress subsequently enacted legislation to ensure the sunset of the waivers in the two treaties. The insurance excise tax also is waived in the treaty with the United Kingdom (without the so-called "anti-conduit rule"). The inclusion of such a waiver in that treaty has been followed by a number of legislative efforts to redress the perceived competitive imbalance created by the waiver.

The proposed treaty waives imposition of the excise tax on insurance and reinsurance premiums paid to residents of Switzerland. The Committee understands that, unlike Bermuda and Barbados, Switzerland imposes substantial tax on the income, including insurance income, of its residents. Moreover, unlike in the case of the U.K. treaty, the waiver in the proposed treaty contains the anti-conduit clause.

As part of its consideration of the proposed treaty, the Committee asked the Treasury Department whether the Swiss income tax imposed on Swiss insurance companies on insurance premiums results in a burden that is substantial in relation to the U.S. tax on U.S. insurance companies. The relevant portion of the October 8, 1997 Treasury Department letter responding to this inquiry is reproduced below:

> [T]he Treasury agrees to cover the federal excise tax on insurance premiums only when it determines that insurance companies resident in the treaty partner are subject to a substantial level of taxation. The Treasury studied Swiss insurance taxation very thoroughly, including meetings with outside experts and Swiss tax officials, before making the initial decision to cover the tax. Consultations were then

[6] Limited consultations took place in connection with the proposed treaty.

held with Senate and House Committee staff members before a final decision was made. We believe that coverage, and thus, waiver, of the tax represents appropriate policy.

In light of the inclusion in the proposed treaty of the anti-conduit clause and based on the assessment provided by the Treasury Department regarding the relative tax burdens of Swiss insurers and U.S. insurers, the Committee believes that the waiver of the excise tax for Swiss insurers is consistent with the criteria the Committee has articulated for such waivers. However, the Committee instructs the Treasury Department promptly to notify the Committee of any changes in laws or business practices that would have an impact on the tax burden of Swiss insurers relative to that of U.S. insurers.

D. 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. In the case of profits derived from the rental of ships and aircraft, the rule limiting the right to tax to the country of residence applies to such rental profits only if the rental profits are incidental to other profits from the operation of ships and aircraft in international traffic. Rental profits that are *not* incidental to other income from the international operation of ships and aircraft generally would be taxable by the source-country as business profits if such profits are attributable to a permanent establishment. The U.S. model and many other treaties provide that profits from the rental of ships and aircraft operated in international traffic are taxable only in the country of residence, without requiring that the rental profits be incidental to income of the recipient from the operation of ships and aircraft. Under the proposed treaty, unlike under the U.S. model, an enterprise that engages only in the *rental* of ships and aircraft, 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.

In addition, the provisions in the U.S. model and many other U.S. income tax treaties that allow profits from an enterprise's operation of ships or aircraft in international traffic to be taxed only in the enterprise's country of residence generally apply also to income from the use, maintenance, or rental of containers used in international traffic. The provision in the proposed treaty does not cover income from containers. Accordingly, under the proposed treaty, income from containers used in international traffic would be taxable by the source-country as business profits if such income is attributable to a permanent establishment.

As part of its consideration of the proposed treaty, the Committee asked the Treasury Department about the treatment of income from rentals of ships, aircraft, and containers under the proposed treaty. The relevant portion of the October 8, 1997 Treasury Department letter responding to this inquiry is reproduced below:

The rule in the Swiss treaty follows the OECD Model, rather than the U.S. Model. This reflects Swiss policy. . . . [I]ncome from the rental of ships, aircraft and containers that is not incidental to the operation of ships and aircraft in international traffic is, under the proposed treaty, treated as business profits, not as shipping income taxable only in the residence of the recipient of the income. Because of this characterization, such income is subject to tax in the source- country only when the rental income is attributable to a permanent establishment in the source-country, and, if taxable, may be taxed only on a net basis. As a general matter, rental contracts will be structured so that the income will not be attributable to a permanent establishment. Thus, this rule differs substantially from the rule in some other treaties, such as Indonesia, where non-incidental income from the leasing of containers was treated as royalties and subject to a 10% gross basis tax. While this rule is not preferred U.S. policy, as part of a negotiated agreement, it provides a reasonable and practical solution, taking into account all applicable Swiss tax rules.

In the past, the Committee has expressed concern about the anti-competitive effects of a provision, such as the provision in the U.S.–Indonesia treaty, that treats non-incidental income from container leasing as royalty income subject to a source-country withholding tax. The Committee understands that under the proposed treaty income derived by a resident of one country from the rental of ships, aircraft, and containers would be subject to tax in the other country only if such income is attributable to a permanent establishment maintained by the resident in the other country. Although the circumstances under which source-country taxation will apply to income from the rental of ships, aircraft, and containers are more limited in the proposed Swiss treaty than in the Indonesian treaty, the Committee continues to reject the notion that a justifiable distinction can be made between container leasing income and income derived from other international transportation activities. The Committee once again urges the Treasury Department to include only the U.S. model provision with respect to such income in all future treaties.

E. TREATY SHOPPING

The proposed treaty, like many U.S. income tax treaties, generally limits treaty benefits for treaty country residents so that only those residents with a sufficient nexus to a treaty country will receive treaty benefits. Although the proposed treaty generally is intended to benefit residents of Switzerland and the United States only, residents of third countries sometimes attempt to use a treaty to obtain treaty benefits. This is known as treaty shopping. Investors from countries that do not have tax treaties with the United States, or from countries that have not agreed in their tax treaties with the United States to limit source-country taxation to the same extent that it is limited in another treaty may, for example, attempt to reduce the tax on interest on a loan to a U.S. person by lending money to the U.S. person indirectly through a country whose treaty with the United States provides for a lower rate of withholding tax on interest. The third-country investor may attempt to do this by establishing in that treaty country a subsidiary, trust, or other entity which then makes the loan to the U.S. person and claims the treaty reduction for the interest it receives.

The anti-treaty-shopping provision in the proposed treaty is similar to anti-treaty-shopping provisions in the Internal Revenue Code ("Code") (as interpreted by Treasury regulations) and in the U.S. model. The provision also is similar to the anti-treaty-shopping provision in several recent treaties. In particular, the proposed treaty provision resembles the anti-treaty-shopping provisions contained in the 1993 U.S. treaty with the Netherlands and the 1995 U.S. treaty with France. The degree of detail included in this provision is notable in itself. The proliferation of detail may reflect, in part, a diminution in the scope afforded the IRS and the courts to resolve interpretive issues adversely to a person attempting to claim the benefits of a treaty; this diminution represents a bilateral commitment, not alterable by developing internal U.S. tax policies, rules, and procedures, unless enacted as legislation that would override the treaty. (In contrast, the IRS generally is not limited under the proposed treaty in its discretion to allow treaty benefits under the anti-treaty-shopping rules.) The detail in the proposed treaty does represent added guidance and certainty for taxpayers that may be absent under treaties that may have somewhat simpler and more flexible provisions.

The anti-treaty-shopping provisions in the proposed treaty differ from those in the Code and other treaties in a number of respects.

The proposed treaty is similar to other U.S. treaties and the branch tax rules in affording treaty benefits to certain publicly traded companies. In comparison with the U.S. branch tax rules, the proposed treaty is more lenient. The proposed treaty allows benefits to be afforded to a company that is more than 50 percent owned, directly or indirectly, by one or more qualifying publicly traded corporations, while the branch tax rules allow benefits to be afforded only to a wholly-owned subsidiary of a publicly traded company.

The proposed treaty also provides mechanical rules under which so-called "derivative benefits" are afforded.[7] Under these rules, an entity is afforded certain benefits based in part on its ultimate ownership of at least 70 percent by residents of European Union, European Economic Area, or North American Free Trade Agreement ("NAFTA") countries who would be entitled to treaty benefits that are as favorable under an existing treaty with the third country. In addition, the Memorandum of Understanding effectively expands this derivative benefits provision. Under this expansion, an entity generally is entitled to all benefits of the treaty based in part on its ultimate ownership of at least 95 percent by seven or fewer residents of European Union, European Economic Area, or NAFTA countries who would be entitled to treaty benefits that are as favorable under an existing treaty with the third country. The U.S. model does not contain a derivative benefits provision.

Taken as a whole, some may argue that the derivative benefits provision of the proposed treaty is more generous to taxpayers claiming U.S. treaty benefits than the derivative benefits provisions of any U.S. tax treaties currently in effect. For example, while most other treaties to which the United States is a party generally allow derivative benefits only with respect to certain income (e.g., interest, dividends or royalties), the proposed treaty allows a taxpayer to claim derivative benefits with respect to the entire treaty.[8] In addition, unlike most existing treaties, the proposed treaty, as supplemented by the Memorandum of Understanding,

[7] The U.S. income tax treaties with the Netherlands, Jamaica and Mexico also provide similar benefits.

[8] The U.S.–Jamaica tax treaty is the only other existing treaty that allows a taxpayer to claim derivative benefits with respect to the entire treaty.

does not require any same-country ownership of a Swiss company claiming treaty benefits.[9] In other words, a Swiss entity that is 100-percent owned by certain third-country residents and that does not otherwise have a nexus with Switzerland (e.g., by engaging in an active trade or business there), may be entitled to claim benefits under the proposed treaty.

The proposed treaty includes a special rule designed to prevent the proposed treaty from reducing or eliminating U.S. tax on income of a Swiss resident in a case where no other substantial tax is imposed on that income (the so-called "triangular cases"). This is necessary because a Swiss resident may in some cases be wholly or partially exempt from Swiss tax on foreign (i.e., non-Swiss) income. The special rule applies generally if the combined Swiss and third-country taxation of U.S.-source income derived by a Swiss enterprise and attributable to a permanent establishment in the third country is less than 60 percent of the tax that would be imposed if the Swiss enterprise earned the income in Switzerland.

Under the special rule, the United States is permitted to tax dividends, interest, and royalties paid to the third-country permanent establishment at the rate of 15 percent. In addition, under the special rule, the United States is permitted to tax other types of income without regard to the proposed treaty. The special rule generally does not apply if the U.S. income is derived in connection with, or is incidental to, an active trade or business in the third country. The special rule is similar to a provision of the 1993 protocol to the U.S.–Netherlands tax treaty and a provision of the U.S.–France treaty. This special rule for triangular cases is not included in the U.S. model.

The U.S.–France treaty provides a further exception from the application of the special rule for the triangular case if the third-country income is subject to taxation by either the United States or France under the controlled foreign corporation rules of either country.[10] Although the proposed treaty does not provide an explicit controlled foreign corporation exception, the Committee expects that the U.S. competent authority would grant relief under the proposed treaty in a case where the U.S.-source income subject to the special rule ultimately is included in a U.S. shareholder's income under the subpart F rules. The Committee believes that either an explicit controlled foreign corporation exception should have been included in the text of the proposed treaty, as in the French treaty and the proposed treaties with Austria and South Africa, or the availability of such relief should have been described in the Technical Explanation of the proposed treaty, as in the case of the proposed treaty with Luxembourg.

The practical difference between the proposed treaty tests and the corresponding tests in other treaties will depend upon how they are interpreted and applied. Given the relatively bright line rules

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[9] Article 26(4)(a) of the U.S.–Netherlands treaty, for example, requires more than 30-percent Dutch ownership of the entity claiming derivative benefits and more than 70-percent European Union ownership of such entity. On the other hand, the 1995 U.S.–Canada protocol permits a company to claim certain treaty benefits under the derivative benefits provision without any same country ownership; however, the benefits that may be so obtained are limited to reduced withholding rates for dividends, interest and royalties.

[10] In the case of the United States, these provisions are contained in sections 951–964 of the Code and are referred to as the "subpart F" rules.

provided in the proposed treaty, the range of interpretation under it may be fairly narrow.

As part of its consideration of the proposed treaty, the Committee asked the Treasury Department about the sufficiency of the anti-treaty-shopping provision in the proposed treaty. The relevant portion of the October 8, 1997 Treasury Department letter responding to this inquiry is reproduced below:

> Like our Netherlands treaty, there is considerable detail in the Swiss limitation on benefits provisions and Memorandum of Understanding. The Swiss wanted this to be able to provide a measure of certainty to taxpayers as to whether they would be entitled to treaty benefits. Many of the aspects of the Swiss provision, such as derivative benefits, we believed were necessary to avoid setting up a situation where potential investors could invest in the United States through some U.S. treaty partners without violating the limitation on benefits provisions, but could not do so through Switzerland. A company that satisfies the derivative benefits provision will be entitled to all the benefits of the treaty, just as in the U.S.–France treaty. The Swiss provision contains a "triangular case" rule, not found in the U.S. Model, because this is necessary for countries that exempt certain third- country permanent establishment profits. Some of the differences between the Swiss anti-treaty-shopping provisions and the standard U.S. Model provisions grew out of the fact that Switzerland has had its own anti-treaty-shopping rules since 1962, and we sought in negotiating the treaty provisions to mesh their system with ours. We believe that the Swiss treaty provision will deal appropriately with potential treaty shoppers.

The Committee believes that the United States should maintain its policy of limiting treaty-shopping opportunities whenever possible. The Committee further believes that, in exercising any latitude Treasury has with respect to the operation of a treaty, the treaty rules should be applied to deter treaty-shopping abuses. On the other hand, the Committee recognizes that implementation of the detailed tests for treaty shopping set forth in the proposed treaty may raise factual, administrative, or other issues that cannot currently be foreseen. The Committee emphasizes that the provisions in the proposed treaty must be implemented so as to serve as an adequate tool for preventing possible treaty-shopping abuses in the future.

F. ARBITRATION OF COMPETENT AUTHORITY ISSUES

The proposed treaty would allow for a binding arbitration procedure, if agreed by both competent authorities and the taxpayer or taxpayers involved, for the resolution of those disputes in the interpretation or application of the proposed treaty that are within the jurisdiction of the competent authorities to resolve. The competent authorities could release to the arbitration board such information as is necessary to carry out the arbitration procedure. The members of the arbitration board are subject to the limitations on disclosure contained in the exchange of information article of the proposed treaty. This provision would take effect only after an exchange of diplomatic notes between the United States and Switzerland.

Generally, the jurisdiction of the competent authorities under the proposed treaty is as broad as it is under any U.S. income tax treaties. For example, the competent authorities are empowered (in this as in other treaties) to agree on the attribution of income, deductions, credits, or allowances of an enterprise to a permanent establishment. They may agree on the allocation of income, deductions, credits, or allowances between associated enterprises and others under the provisions of Article 9 (Associated Enterprises), which is the treaty analogue of Code section 482. They also may agree on the characterization of particular items of income, on the common meaning of a term, and on the application of procedural aspects of internal law. Finally, the competent authorities may agree on the elimination of double taxation in cases not provided for in the proposed treaty. According to the Technical Explanation with respect to this procedure, agreements reached by the competent authorities need not conform to the internal law provisions of either treaty country.

As part of its consideration of the proposed treaty, the Committee asked the Treasury Department about the appropriateness of the arbitration provision contained in the proposed treaty. The relevant portion of the October 8, 1997 Treasury Department letter responding to this inquiry is reproduced below:

> Treasury recognizes that there has been little practical experience with arbitration of tax treaty disputes and this creates some uncertainty about how well arbitration would work. For this reason, Treasury does not advocate the inclusion of arbitration provisions in new treaties. However, if the treaty partner is strongly interested in an arbitration provision, we are willing to include such a provision in a new treaty with the proviso that it cannot be implemented until the treaty partners have exchanged diplomatic notes to that effect. This provides the opportunity to wait until more experience has been gained with arbitration and with the treaty partner before deciding whether the implementation of such a provision is desirable.

The Committee continues to believe that the tax system potentially may have much to gain from use of a procedure, such as arbitration, in which independent experts can resolve disputes that otherwise may impede efficient administration of the tax laws. However, the Committee also believes that the appropriateness of such a clause in a future treaty depends strongly on the other party to the treaty, and on the experience that the competent authorities have under the arbitration provision in the German treaty. The Committee understands that to date there have been no arbitrations of competent authority cases under the German treaty, and few tax arbitrations outside the context of that treaty. The Committee believes that it is appropriate to have conditioned the effectiveness of the arbitration provision in the proposed treaty on subsequent action which should occur only after review of future developments in this evolving area of international tax administration.

VII. Budget Impact

The Committee has been informed by the staff of the Joint Committee on Taxation that the proposed treaty is estimated to cause a negligible change in fiscal year Federal budget receipts during the 1998–2007 period.

VIII. Explanation of Proposed Treaty and Proposed Protocol

A detailed, article-by-article explanation of the proposed treaty between the United States and Switzerland, as supplemented by the proposed protocol, is presented below. In the explanation below, the understandings and interpretations reflected in the Memorandum of Understanding are covered together with the relevant articles of the proposed treaty.

Article 1. Personal Scope

The personal scope article describes the persons who may claim the benefits of the proposed treaty. The proposed treaty generally applies to residents of the United States and residents of Switzerland. However, other articles of the proposed treaty provide for specific expansions of this scope to persons that are residents of neither the United States nor Switzerland for purposes of such articles (e.g., Article 24 (Non-Discrimination) and Article 26 (Exchange of Information)). The determination of whether a person is a resident of the United States or Switzerland is made under the provisions of Article 4 (Resident).

Like all U.S. income tax treaties, the proposed treaty is subject to a "saving clause." The saving clause in the proposed treaty is drafted unilaterally to apply only to the United States. Under this clause, with specific exceptions described below, the proposed treaty is not to affect the U.S. taxation of its residents or its citizens. By reason of this saving clause, unless otherwise specifically provided in the proposed treaty, the United States will continue to tax its citizens who are residents of Switzerland as if the treaty were not in force. Similarly, the United States will continue to tax persons that are treated as U.S. residents under U.S. tax law as if the treaty were not in force, unless such persons are treated as residents of Switzerland under the treaty tie-breaker rules governing dual residents provided in Article 4 (Resident). The term "residents" includes corporations and other entities as well as individuals.

The proposed treaty contains a provision under which the saving clause (and therefore the U.S. jurisdiction to tax) applies to former U.S. citizens. Under the U.S. model, the saving clause applies to both former citizens and former long-term residents. The Code provides special rules for the imposition of U.S. income tax on former U.S. citizens for a period of ten years following their loss of U.S. citizenship. The Health Insurance Portability and Accountability Act of 1996 extended the special income tax rules for former U.S. citizens to apply also to certain former long-term residents of the United States. The proposed treaty provision reflects the reach of the U.S. tax jurisdiction pursuant to these special rules prior to its extension to former U.S. long-term residents. Accordingly, the saving clause in the proposed treaty does not permit the United States to impose tax on former U.S. long-term residents who otherwise would be subject to the special income tax rules contained in the Code.

Exceptions to the saving clause are provided for the following benefits conferred by the United States pursuant to the proposed treaty: the provision for correlative adjustments to the profits of an enterprise following an adjustment by Switzerland of the profits of a related enterprise (Article 9, paragraph 2); the coordination of the timing of gain recognition with respect to certain cross-border transactions (Article 13, paragraphs 6 and 7); the provisions for relief from double taxation (Article 23); the non-discrimination rules (Article 24); and the mutual agreement procedures (Article 25). These exceptions to the saving clause allow the provision of the enumerated benefits to citizens and residents of the United States, without regard to U.S. internal law.

In addition, exceptions from the saving clause are provided for certain benefits conferred by the United States pursuant to the proposed treaty, but only in the case of an individual who neither is a U.S. citizen nor has immigrant status in the United States. Under this rule, the specified benefits under the proposed treaty are available to an individual who spends enough time in the United States to be taxed as a U.S. resident under Code section 7701(b), provided that the individual has not acquired U.S. immigrant status (i.e., is not a green-card holder). The following benefits are subject to this rule: the exemption from U.S. tax on compensation from government service to Switzerland (Article 19, paragraphs 1 and 2); the exemption from U.S. tax on certain income received by temporary visitors who are students or trainees (Article 20); the special rules applicable to diplomatic agents and consular officers (Article 27); and the exemption from U.S. tax on certain contributions to a pension or other retirement arrangement (Article 28, paragraph 4).

Article 2. Taxes Covered

The proposed treaty generally applies to the income taxes of the United States and Switzerland. As discussed below, the proposed treaty specifies the particular covered taxes of each country. However, the non-discrimination rules of Article 24 apply to taxes of all kinds imposed by either country or its political subdivisions or local authorities.

In the case of Switzerland, the proposed treaty, like the present treaty, covers the federal, cantonal, and communal taxes on income. The proposed treaty applies to such income taxes regardless of whether they are imposed on total income, earned income, income from property, business profits, or some other measure of income. The proposed treaty does not cover any Swiss taxes on capital.

In the case of the United States, the proposed treaty, like the present treaty, applies to the Federal income taxes imposed by the Code. The proposed protocol contains a specific exclusion for U.S. social security taxes (but not for the income taxes on social security benefits). Like the U.S. model and the present treaty, but unlike some other U.S. income tax treaties in force, the proposed treaty applies to the accumulated earnings tax and the personal holding company tax. In addition, the proposed treaty applies to the U.S. excise taxes imposed on insurance premiums paid to foreign insurers and the U.S. excise tax imposed with respect to private foundations. The present treaty does not apply to any excise taxes.

The proposed treaty applies to the excise taxes on insurance premiums paid to foreign insurers only to the extent that the risks covered by such premiums are not reinsured with a person that is not entitled to an exemption from such taxes either under the proposed treaty or under any other treaty. Because the insurance excise taxes are covered taxes under the proposed treaty, Swiss 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 Swiss insurer reinsures a policy it has written on a U.S. risk with a foreign reinsurer that is not entitled to a similar exemption under this or a different tax treaty. Because the present treaty does not cover excise taxes, the U.S. insurance excise taxes may be imposed on Swiss insurers under the present treaty.

The proposed treaty also contains a provision generally found in U.S. income tax treaties (including the present treaty) that applies the treaty to any identical or substantially similar taxes that either country may subsequently impose. The proposed treaty obligates the competent authority of each country to notify the competent authority of the other country of any significant changes in its internal tax laws. Unlike the U.S. model, the proposed treaty does not specifically obligate the competent authorities to notify each other of significant changes in other laws affecting their obligations under the proposed treaty or of any official published material regarding the application of the proposed treaty.

Article 3. General Definitions

This article provides definitions of terms used in the proposed treaty that apply for all purposes of the proposed treaty, unless the context requires otherwise. These definitions generally are consistent with the definitions contained in the U.S. model. In addition, certain terms are defined in the articles in which such terms are used.

The term "person" includes an individual, a partnership, a company, an estate, a trust and any other body of persons. A "company" is any body corporate or any entity which is treated as a body corporate for tax purposes under the laws of the country in which it is organized.

An "enterprise of a Contracting State" is defined as an enterprise carried on by a resident of that country. Similarly, an "enterprise of the other Contracting State" is defined as an enterprise carried on by a resident of the other Contracting State. The proposed treaty does not define the term "enterprise." The Technical Explanation states that it is understood to mean any activity or set of activities that constitutes a trade or business.

In the case of the United States, the term "national" means U.S. citizens and all legal persons, partnerships, and associations deriving their status as such from the laws in force in the United States. In the case of Switzerland, the term "national" means all individuals possessing Swiss nationality and all legal persons, partnerships, and associations deriving their status as such from the laws in force in Switzerland.

The term "international traffic" means any transport by a ship or aircraft, other than transport solely between two points within the other country. The Technical Explanation states that transport that constitutes international traffic includes any portion of the transport that is between two points within the other country, even if the internal portion of the transport involves a transfer to a land vehicle or is handled by an independent contractor (provided that the original bills of lading include such portion of the transport).

The Swiss competent authority is the Director of Federal Tax Administration or his authorized representative. The U.S. competent authority is the Secretary of the Treasury or his delegate. In fact, the U.S. competent authority function has been delegated to the Commissioner of Internal Revenue, who has redelegated the authority to the Assistant Commissioner (International) of the IRS. On interpretative issues, the latter acts with the concurrence of the Associate Chief Counsel (International) of the IRS.

The term "Switzerland" means the Swiss Confederation.

The term "United States" means the United States of America, but does not include Puerto Rico, the Virgin Islands, Guam or any other U.S. possession or territory.

The proposed treaty also provides that, unless the context otherwise requires or the competent authorities of the two countries agree to a common meaning, all terms not defined in the treaty are to have the meanings which they have under the tax laws of the country whose tax is being applied. The Technical Explanation states that a meaning of a term provided under the tax laws of a country will take precedence over a meaning of such term under other laws of the country.

Article 4. Resident

The assignment of a country of residence in a treaty is important because the benefits of the treaty generally are available only to a resident of one of the treaty countries as that term is defined in the treaty. Furthermore, double taxation often is avoided by the assignment of a single treaty country as the country of residence when, under the internal laws of the treaty countries, a person is a resident of both. The present treaty does not include a definition of "resident."

Under U.S. law, residence of an individual is important because a resident alien is taxed on 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 substantial time in the United States in any year or over a three-year period generally is treated as a U.S. resident (Code sec. 7701(b)). A permanent resident for immigration purposes (i.e., a green-card holder) also is treated as a U.S. resident. Under the Code, a company is domestic, and therefore taxable on its worldwide income, if it is organized in the United States or under the laws of the United States, a State, or the District of Columbia.

The proposed treaty generally defines the term "resident of a Contracting State" to mean any person who, under the laws of that country, is liable to tax therein by reason of his or her domicile, residence, nationality, place of management, place of incorporation, or any other criterion of a similar nature. Although citizenship is not specified as a criterion of residence, nationality is so specified and is defined in Article 3 (General Definitions) to mean citizenship in the case of the United States.

A U.S. citizen or green-card holder who is not a resident of Switzerland is treated as a U.S. resident under the proposed treaty only if the individual has a substantial presence, permanent home, or habitual abode in the United States. Unlike under the U.S. model, citizenship alone does not establish residence. As a result, U.S. citizens residing overseas are not necessarily entitled to the benefits of the proposed treaty as U.S. residents. In the case of a U.S. citizen or green-card holder who is also a resident of Switzerland, such individual's residence is determined under the treaty tie-breaker rule described below.

The proposed protocol provides that if a Swiss resident makes an election to be treated as a U.S. resident in order to file a joint U.S. income tax return with his or her spouse (who is a U.S. citizen or resident), such individual will continue to be treated as a resident of Switzerland, but also will be subject to tax as a U.S. resident. Accordingly, such an individual will be treated under the proposed treaty in the same manner as a U.S. citizen who is a Swiss resident.

The government of a treaty country, a political subdivision or local authority thereof, or any agency or instrumentality of such government, subdivision, or authority is considered to be a resident of that country. The Memorandum of Understanding provides that it is understood that the term "government" includes any body that constitutes a governing authority of a treaty country or political subdivision, provided that the net earnings of the governing authority are credited to its own account or other accounts of the treaty country or political subdivision and no portion of such net earnings inure to the benefit of any private person. The Memorandum of Understanding further provides that the term "government" includes a corporation that is not engaged in commercial activities and that is wholly owned directly or indirectly by a treaty country or political subdivision; however, this rule applies only if the corporation is organized under the laws of the treaty country or political subdivision, its earnings are credited to its own account or to an account of the treaty country or political subdivision, and its assets vest in the treaty country or political subdivision upon dissolution. Finally, the Memorandum of Understanding provides that the term "government" includes a pension trust of a treaty country or political subdivision that does not engage in commercial activities and that is established and operated exclusively to provide pension benefits to employees or former employees of the treaty country or political subdivision. This is consistent with the definition contained in Code section 892.

Special rules apply to treat as residents of a treaty country certain organizations that generally are exempt from tax in that country. Under these rules, pension trusts and any other organizations established in a treaty country and maintained exclusively to administer or provide pension, retirement or employee benefits are treated as residents of such country if they are established or sponsored by a person resident in such country. Similarly, non-profit organizations established and maintained in a treaty country for religious, charitable, educational, scientific, cultural, or other public purposes are treated as residents of such country.

A special rule also is provided for partnerships, estates and trusts. A partnership, estate, or trust is treated as a resident of a treaty country only to the extent that income derived by such entity is subject to tax, either in the entity's hands or in the hands of its partners or beneficiaries, in such country in the same manner as income of a resident of the country.

The term "resident of a Contracting State" does not include any person who is liable to tax in that country in respect only of income from sources 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 rules, would be considered to be a resident of both countries. Such a dual resident 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., the “center of vital interests”). If the country in which the individual has his or her center of vital interests cannot be determined, or if the individual does not have a permanent home available in either country, such individual 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, the individual 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 are to settle the question of residence by mutual agreement.

In the case of an entity that would be considered to be a resident of both countries under the basic treaty definition, the proposed treaty provides that the entity is treated as a resident of one of the treaty countries only if and to the extent the competent authorities so agree. If the competent authorities are unable to reach such an agreement, the entity generally will be ineligible for benefits under the proposed treaty. This issue may be submitted for arbitration under the rules specified in Article 25 (Mutual Agreement Procedure). In this regard, the proposed treaty is similar to some existing U.S. treaties, but dissimilar to the U.S. model, which does not specify that treaty benefits will be denied in cases where the competent authorities cannot agree.

Under the proposed treaty, an individual who otherwise would be treated as a Swiss resident will not be so treated for purposes of the proposed treaty if the individual elects not to be subject to the generally applicable Swiss income taxes with respect to all U.S.-source income. This rule applies to alien residents of Switzerland who elect to be taxed under an alternative regime available in Switzerland instead of under the generally-applicable Swiss income tax.

Article 5. Permanent Establishment

The proposed treaty contains a definition of the term “permanent establishment” that generally follows the pattern of 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 amounts are taxed as business profits.

In general, under the proposed treaty, a permanent establishment is a fixed place of business through which an enterprise carries on business in whole or in part. A permanent establishment includes (but is not limited to) a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources. It also includes any building site or construction or installation project, or an installation or drilling rig or ship used for the exploration or development of natural resources, if it lasts for more than 12 months. The Technical Explanation states that the 12-month test applies separately to each site or project, but that projects that are commercially and geographically interdependent are to be treated as a single project. The Technical Explanation further states that if the 12-month threshold is exceeded, the site or project is treated as a permanent establishment from the first day of activity.

Notwithstanding this general definition of a permanent establishment, the proposed treaty provides that the following specified activities do not constitute a permanent establishment: the use of facilities solely for storing, displaying, or delivering goods or merchandise belonging to the enterprise; 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; the maintenance of a fixed place of business solely for the purchase of goods or merchandise or the collection of information for the enterprise; the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, advertising, the supply of information, scientific research, or other activities of a preparatory or auxiliary character. The proposed treaty provides that the maintenance of a fixed place of business solely for any combination of these activities does not constitute a permanent establishment, provided that the overall activity resulting from such combination is of a preparatory or auxiliary character. In contrast, the U.S. model provides that such a combination of activities does not give rise to a permanent establishment without regard to whether the combination is of a preparatory or auxiliary character.

If a person, other than an independent agent, is acting on behalf of an enterprise and has and habitually exercises in a country the authority to conclude contracts in the name of an enterprise, the enterprise generally will be deemed to have a permanent establishment in that country in respect of any activities that person undertakes for the enterprise. This rule does not apply where the activities of such person is limited to those activities described above, such as storage, display, or delivery of merchandise, which do not constitute a permanent establishment.

The proposed treaty further provides that no permanent establishment is deemed to arise based on an agent's activities if the agent is a broker, general commission agent, or any other agent of independent status acting in the ordinary course of its business. The Technical Explanation states that an independent agent is one that is both legally and economically independent of the enterprise. Whether an agent and an enterprise are independent depends on the facts and circumstances of the particular case.

The fact that a company that is resident in one country controls or is controlled by a company that is a resident of the other country, or that carries on business in that 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, but not gains, from real property. The rules covering gains from the sale of real property are contained in Article 14 (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 real property is situated. Income from real property includes income from agriculture or forestry. The country in which the real property is situated is not, however, granted an exclusive right to tax the income derived from the real property; such income also may be taxed in the recipient's country of residence.

The term "real property" generally has the meaning that it has under the law of the country in which the property in question is situated. In the case of the United States, the term "real property" is defined in Treas. Reg. sec. 1.897–1(b). However, like the OECD model, the proposed treaty specifies that the term includes property accessory to real property, livestock and equipment used in agriculture and forestry, rights with respect to which the law of landed property applies, usufruct of real property, and rights to payment with respect to the working of mineral deposits and other natural resources. The proposed treaty further specifies that ships and aircraft do not constitute real property.

The country in which real property is situated may tax income derived from the direct use, letting, or use in any other form of such property. The rules of this article allowing source-country taxation also apply to income from real property of an enterprise and to income from real property used for the performance of independent personal services. Accordingly, income from real property may be taxed by the country in which it is situated even though such income is not attributable to a permanent establishment or fixed base in such country.

The proposed treaty provides residents of a country that are taxable in the other country on income from real property situated in the other country with an election, subject to the procedures of the domestic law of the country in which the property is situated, to be taxed by the other country on such income on a net basis as if such income were attributable to a permanent establishment or fixed base. Such election is binding for taxable years as provided by the domestic law of the country in which the property is located. U.S. internal law provides such a net-basis election in the case of income of a foreign person from U.S. real property (Code secs. 871(d) and 882(d)).

Article 7. Business Profits

U.S. internal law

U.S. law distinguishes between the U.S. business income and 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) which is effectively connected with the conduct of a trade or business within the United States.

The treatment of income as effectively connected with a U.S. 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, and rents) 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.

Foreign-source income generally is treated as 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 in the case of insurance companies.

Any income or gain of a foreign person for any taxable year that is attributable to a transaction in another taxable 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 taxable year (Code sec. 864(c)(6)).

Proposed treaty limitations on internal law

Under the proposed treaty, business profits of an enterprise of one country 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.

The taxation of business profits under the proposed treaty differs from U.S. rules for taxing business profits primarily by requiring more than merely being engaged in a trade or business before a country can tax business profits and by substituting an "attributable to" standard for the Code's "effectively connected" standard. Under the Code, all that is necessary for effectively connected business profits to be taxed is that a trade or business be carried on in the United States.

The present treaty provides that if a Swiss enterprise has a permanent establishment in the United States, the United States may tax all the U.S.-source income of the permanent establishment. The proposed treaty eliminates this "force of attraction" rule. On the other hand, unlike the present treaty, the proposed treaty permits the United States to tax certain non-U.S.-source income of a permanent establishment of a Swiss enterprise.

Under the proposed treaty, the business profits of a permanent establishment are determined on an arm's-length basis. The proposed treaty provides that the business profits attributed to a permanent establishment are determined based on the profits it would make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions. The proposed treaty further provides that the business profits to be attributed to the permanent establishment include only the profits derived from the assets or activities of the permanent establishment. The proposed treaty is consistent with the U.S. model and other existing U.S. treaties in this respect. Amounts may be attributed to the permanent establishment whether they are from sources within or without the country in which the permanent establishment is located.

The Memorandum of Understanding specifically addresses the attribution of profits to a permanent establishment in the case of contracts for the survey, supply, installation, or construction of public works or industrial, commercial, or scientific equipment or premises. The profits attributable to the permanent establishment are determined on the basis only of the portion of such a contract that is effectively carried out by the permanent establishment and not on the basis of the total amount of the contract. The profits attributable to the portion of the contract carried out by the enterprise's head office are not taxable in the country in which the permanent establishment is situated.

In computing business profits, the proposed treaty provides that deductions are allowed for expenses incurred for the purposes of the permanent establishment. These deductions include 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). This rule applies without regard to where such expenses are incurred. According to the Technical Explanation, it is expected that each country will use its own expense allocation rules. This rule permits the United States to use its current expense allocation rules in determining deductible amounts. Thus, for example, a Swiss company which has a permanent establishment in the United States but which has its head office in Switzerland will, in computing the U.S. tax liability of the permanent establishment, be entitled to deduct a portion of the executive and general administrative expenses incurred in Switzerland by the head office for purposes of operating the U.S. permanent establishment, allocated and apportioned in accordance with Treas. Reg. section 1.861–8.

Like the OECD model, the proposed treaty provides that a country may determine the business profits attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise. If it is customary in a country to use a total profits apportionment method, such method may be used pursuant to the proposed treaty, provided that the method of apportionment gives results that are consistent with the arm's-length principle of this article. This rule is not specified in the U.S. model; however, the provisions of the U.S. model permit the use of a total profits apportionment method as a means of determining arm's-length profits. The Technical Explanation states that methods other than separate accounting may be used to estimate the arm's-length profits of a permanent establishment, provided that the method approximates the results that would be achieved under a separate accounting approach.

Business profits are not attributed to a permanent establishment merely by reason of the purchase of goods or merchandise by a permanent establishment for the enterprise. Thus, where a permanent establishment purchases goods for its head office, the business profits attributed to the permanent establishment with respect to its other activities are not increased by the profit element with respect to its purchasing activities.

The proposed treaty provides that the amount of profits attributable to a permanent establishment must be determined by the same method each year unless there is good and sufficient reason to change the method.

Where business profits include items of income which are dealt with separately in other articles of the treaty, those other articles, and not the business profits article, govern the treatment of such items of income. Thus, for example, profits attributable to a U.S. ticket office of a Swiss airline generally are exempt from U.S. Federal income tax under the provisions of Article 8 (Shipping and Air Transport). This rule does not apply, however, where the other article specifically provides that this article takes precedence (e.g., Article 10 specifically provides that dividends attributable to a permanent establishment are taxable as business profits).

Unlike the U.S. model, the proposed treaty does not contain a general definition of "business profits." The Technical Explanation states that such term should be read to include all income derived from any trade or business. The proposed treaty specifies that the term "business profits" includes income derived from the rental of tangible movable property and the rental or licensing of cinematographic films or works on film, tape, or other means of reproduction for use in radio or television broadcasting. Accordingly, such income may be taxed in the source- country only if the income is attributable to a permanent establishment. The Technical Explanation states that the term "business profits" is understood to include income attributable to notional principal contracts and other financial instruments to the extent such income is related to a trade or business carried on through the permanent establishment.

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 sale of ships and aircraft operated in international traffic are contained in Article 13 (Gains).

Under the proposed treaty, profits which 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" means any transport by a ship or aircraft except when such transport is operated solely between places in a treaty country (Article 3(1)(e) (General Definitions)). Unlike the exemption provided in the present treaty, the exemption in the proposed treaty applies whether or not the ships or aircraft are registered in the first country.

The Technical Explanation states that income from the rental of ships or aircraft on a full basis for use in international traffic constitutes income from the operation of ships and aircraft in international traffic. Such income therefore is exempt from tax in the other country. In addition the proposed treaty provides that income from the operation of ships or aircraft in international traffic includes profits derived from the rental of ships or aircraft if such rental profits are incidental to profits from the operation of ships or aircraft in international traffic. This rule applies to leases on a bareboat basis. Unlike under the U.S. model, the exemption from tax under the proposed treaty does not apply to a bareboat lessor (such as a financial institution or a leasing company) that does not operate ships or aircraft in international traffic, but that leases ships or aircraft for use in international traffic. In such a case, the rental income constitutes business profits and is subject to tax in the source-country if it is attributable to a permanent establishment. The Technical Explanation states that it is understood that such rental income will not be considered to be attributable to a permanent establishment unless the permanent establishment was involved in negotiating or concluding the lease agreement.

Unlike the U.S. model, the proposed treaty does not address the treatment of containers. Under the U.S. model, income derived by an enterprise of one country from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) used in international traffic is taxable only in that country. Under the proposed treaty, such income constitutes business profits and is taxable under the provisions of Article 7.

As under the U.S. model, the shipping and air transport provisions of the proposed treaty also apply to profits from participation in a pool, joint business, or international operating agency. This rule covers profits derived pursuant to an arrangement for international cooperation between carriers in shipping and air transport.

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 determine the profits taxable by that country in the case of transactions between related enterprises, if the profits of an enterprise do not reflect the conditions which would have been made between independent enterprises.

The redetermination rules of the proposed treaty apply where an enterprise of one country participates directly or indirectly in the management, control, or capital of an enterprise of the other country or the same persons participate directly or indirectly in the management, control, or capital of such enterprises. In such cases, if conditions between the two enterprises in their commercial or financial relations differ from those which would be made between independent enterprises, then any profits which would have accrued to one of the enterprises but for these conditions may be included in the profits of such enterprise and taxed accordingly. This provision allows a country to adjust the income or loss of one or both of the enterprises if they have entered into non-arm's-length transactions.

The Technical Explanation states that it is understood that this provision does not limit the rights of the respective countries to apply their internal intercompany pricing rules (e.g., Code sec. 482, in the case of the United States), provided that such rules are in accord with the arm's-length principle. The Technical Explanation also states that it is understood that the U.S. "commensurate with income" standard for determining appropriate transfer prices for intangibles was designed to operate consistently with the arm's-length standard. Finally, the Technical Explanation states that this rule permits adjustments to address thin capitalization issues.

Under the proposed treaty, where a country proposes to tax as profits of an enterprise profits on which an enterprise of the country has been taxed in such other country, the competent authorities of the countries may consult pursuant to the mutual agreement procedure (Article 25). If the competent authorities agree on adjustments to the profits of each such enterprise reflecting the conditions which would have been made between independent enterprises, each country will make the agreed adjustment to the tax on the profits on each enterprise. To avoid double taxation, the proposed treaty's saving clause retaining full taxing U.S. jurisdiction over U.S. citizens and residents does not apply to prevent such correlative adjustments.

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 as 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.

Dividends paid by a U.S. corporation generally are U.S.-source income. Also treated as U.S.-source income 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 further 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 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 particular, in order to qualify as a REIT, the REIT must distribute the bulk of its income on a current basis. Thus, a REIT is treated, in essence, as a conduit for federal income tax purposes: generally no tax is imposed at the entity level and the shareholders are taxed on a current basis on the REIT's earnings. Because a REIT in form is taxable as a U.S. corporation, a distribution of its earnings is treated as a dividend rather than as 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 real estate 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: generally no tax is imposed at the entity level and the shareholders are taxed on a current basis on the RIC's earnings. 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.

A foreign corporation engaged in the conduct of a trade or business in the United States is subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the accumulated U.S. effectively connected earnings of the corporation that are removed in any year from its U.S. trade or business. The dividend equivalent amount is limited by (among other things) the foreign corporation's aggregate earnings and profits accumulated in taxable years beginning after December 31, 1986. The Code provides that no U.S. treaty shall exempt any foreign corporation from the branch profits tax (or reduce the amount thereof) unless the foreign corporation is a "qualified resident" of the treaty country. The definition of a "qualified resident" under U.S. internal law is somewhat similar to the definition of a corporation eligible for benefits under the proposed treaty (discussed below in connection with Article 22 (Limitation on Benefits)).

Switzerland

Switzerland generally imposes a withholding tax on profit distributions from Swiss corporations at a rate of 35 percent. For this purpose, profit distributions generally include dividends, liquidation proceeds, and hidden profits distributions.

Profits of a branch in Switzerland generally are subject to Swiss income tax. However, Switzerland does not impose a withholding tax on branch profits.

Proposed treaty limitations on internal law

The present treaty provides that dividends derived from sources within one country by a resident of the other country may be taxed by the source-country. The rate of source-country tax generally is limited to 15 percent. However, the rate of tax is limited to 5 percent if the dividend recipient is a corporation controlling (directly or indirectly) at least 95 percent of the voting power of the payor and not more than 25 percent of the gross income of the payor is derived from interest and dividends (other than interest and dividends received from the payor's subsidiaries). This 5-percent rate does not apply if the relationship between the dividend-paying corporation and the dividend-receiving corporation was arranged or maintained primarily with the intention of qualifying for such rate.

Under the proposed treaty, dividends beneficially owned by a resident of one country may be taxed by the residence country without limitation. In addition, such dividends also may be taxed in the country in which such dividends arise. However, source-country taxation is subject to limitations if the beneficial owner of the dividends is a resident of the other country. Under these limitations, source-country tax is limited to 5 percent of the gross amount of the dividends if the beneficial owner is a company that holds directly at least 10 percent of the voting stock of the payor company. Relative to the present treaty, the proposed treaty represents a significant liberalization of the conditions under which the 5-percent rate applies. Under the proposed treaty, source-country tax generally is limited to 15 percent of the gross amount of the dividends in all other cases. The proposed treaty provides that these limitations do not affect the taxation of the company on the profits out of which the dividends are paid.

The proposed treaty provides that the 15-percent limitation (and not the 5-percent limitation) applies to dividends paid by a RIC. The proposed treaty provides that the 15-percent limitation applies to dividends paid by a REIT to an individual owning a less than 10-percent interest in the REIT. There is no limitation in the proposed treaty on the tax that may be imposed by the United States on a REIT dividend, if the beneficial owner of the dividend is either an individual holding a 10 percent or greater interest in the REIT or is not an individual. Thus, such a dividend is taxable at the 30-percent United States statutory rate. The present treaty does not include these limitations on the application of the reduced rates of source-country taxation to dividends from RICs and REITs.

The proposed treaty provides an exemption from source-country tax in the case of dividends beneficially owned by a resident of the other country that is a qualifying pension or other retirement arrangement and that does not control the dividend-paying company. This rule applies to a pension or other retirement arrangement that has been determined by the competent authority to generally correspond to a pension or other retirement arrangement recognized for tax purposes by the source-country. The Technical Explanation states that individual savings plans (such as individual retirement accounts) are not pension or other retirement arrangements for this purpose.

Like the U.S. model, the proposed treaty defines "dividends" as income from shares or other rights, not constituting debt-claims, that participate in profits. Dividends also include income subjected to the same tax treatment as income from shares under the law of the country in which the income arises. The proposed protocol provides that participation in the profits of the obligor is a factor in determining whether an instrument characterized as a debt-claim should be treated as equity for purposes of the proposed treaty.

The proposed treaty's reduced rates of tax on dividends do not apply if the beneficial owner of the dividend carries on business through a permanent establishment (or a fixed base, in the case of an individual who performs independent personal services) in the source-country and the dividends are attributable to the permanent establishment (or fixed base). Such dividends are taxed as business profits (Article 7) or as income from the performance of independent personal services (Article 14). In addition, dividends attributable to a permanent establishment or fixed base, but received after the permanent establishment or fixed base is no longer in existence, are taxable in the country where the permanent establishment or fixed base existed (Article 28, paragraph 3).

The proposed treaty contains a general limitation on the taxation by one country of dividends paid by companies that are residents of the other country. Under this provision, a country may not, except in two cases, impose any taxes on dividends paid by a company resident in the other country that derives profits or income from the first country. The first exception is the case where the dividends are paid to residents of the first country. The second exception is the case where the dividends are attributable to a permanent establishment or a fixed base in the first country.

The proposed treaty allows the United States to impose the branch profits tax on a Swiss resident 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 real property interests. In cases where a Swiss corporation conducts a trade or business in the United States, but not through a permanent establishment, the proposed treaty generally eliminates the branch profits tax that the Code imposes on such corporation.

In general, the proposed treaty provides that the branch profits tax may be imposed by the United States only on the business profits of the Swiss corporation that are attributable to its U.S. permanent establishment and the income that is subject to tax on a net basis as income or gains from real property. The tax is further limited to such amounts that are included in the "dividend equivalent amount," as that term is defined under the Code and as it may be amended from time to time without changing the general principle thereof. The proposed protocol specifies that the general principle of the "dividend equivalent amount" is to approximate the portion of the specified income that is comparable to the amount that would be distributed as a dividend if such income were earned by a U.S. subsidiary. The foreign corporation's dividend equivalent amount is equal to the after-tax earnings attributable to the specified income, reduced by any increase in the corporation's net investment in U.S. assets or increased by any reduction in the corporation's net investment in U.S. assets.

The proposed treaty limits the rate of the U.S. branch profits tax to the direct investment dividend tax rate of 5 percent.

Article 11. Interest

Internal taxation rules

United States

Subject to numerous exceptions (such as those for portfolio interest, bank deposit interest, and short-term original issue discount), the United States imposes a 30-percent 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 to a foreign person 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 a 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 and that (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 is inapplicable 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 in turn 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.

Switzerland

Switzerland generally imposes a withholding tax on interest derived from deposits with Swiss banks and bonds from Swiss debtors at a rate of 35 percent. Switzerland generally does not impose a withholding tax on interest on intercompany loans.

Proposed treaty limitations on internal law

The proposed treaty generally exempts interest derived and beneficially owned by a resident of one country from tax in the other country. The present treaty allows source-country tax at a maximum rate of 5 percent on interest derived by a resident of the other country.

The treaty defines the term "interest" generally as income from debt claims of every kind, whether or not secured by mortgage. In particular, it includes income from government securities and from bonds or debentures, including premiums and prizes attaching to such securities, bonds, or debentures. The term " interest" includes an excess inclusion with respect to a residual interest in a REMIC. Interest does not include income covered in Article 10 (Dividends). Penalty charges for late payment also are not treated as interest. The proposed protocol provides that participation in the profits of the obligor is a factor in determining whether an instrument characterized as a debt claim should be treated as equity for purposes of the proposed treaty.

This exemption from source-country tax does not apply if the beneficial owner of the interest carries on business through a permanent establishment (or a fixed base, in the case of an individual who performs independent personal services) in the source-country and the interest paid is attributable to the permanent establishment (or fixed base). In that event, the interest is taxed as business profits (Article 7) or income from the performance of independent personal services (Article 14). In addition, interest attributable to a permanent establishment or fixed base, but received after the permanent establishment or fixed base is no longer in existence, is taxable in the country where the permanent establishment or fixed base existed (Article 28, paragraph 3).

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 the laws of each country, taking into account the 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 proposed treaty limits the right of one country to tax interest paid by a company that is resident in the other country. The first country may tax interest payments only if the interest is paid by a permanent establishment in that country or is paid out of income or gain from real property that is subject to net-basis taxation in that country. This rule allows the United States to impose tax on certain interest payments made by a Swiss company; however, because of the general rule providing for exclusive residence-country taxation, this rule does not allow the United States to tax such interest payments if made to Swiss residents.

Like the U.S. model, the proposed treaty includes two limitations on the application of the exemption in the case of United States. First, the exemption does not apply to interest arising in the United States if the amount of such interest is determined by reference to receipts, sales, income, profits, or other cash flow of the debtor or a related person, to any change in the value of property of the debtor or a related person, or to any dividend, partnership distribution or similar payment by the debtor or similar person. However, this rule applies only to the extent that such interest is excluded from the definition of portfolio interest under the Code. Second, the exemption does not apply to an excess exclusion with respect to a residual interest in a REMIC. Amounts covered by these two exceptions may be taxed by the United States under the proposed treaty at the full statutory rate of 30 percent.

Article 12. Royalties

Internal taxation rules

Under the same system that applies to dividends and interest, the United States imposes a 30-percent tax on U.S.-source royalties paid to foreign persons and on gains from the disposition of certain intangible property to the extent that such gains are from payments contingent on the productivity, use, or disposition of the intangible property. Royalties are from U.S. sources if they are for the use of property located in the United States. U.S.-source royalties include royalties for the use of, or the right to use, intangible property in the United States. Switzerland does not impose a withholding tax on royalties.

Proposed treaty limitations on internal law

The proposed treaty provides that royalties derived and beneficially owned by a resident of a treaty country may be taxed only by the residence country. Thus, the proposed treaty generally continues the rule of the present treaty that exempts U.S.-source royalties paid to Swiss residents from the 30-percent U.S. tax. This exemption is similar to that provided in the U.S. model.

Royalties are defined as payments of any kind received as consideration for the use of or the right to use any copyright of literary, artistic, or scientific work; for the use of or right to use any patent, trademark, design or model, plan, secret formula or process, or other like right or property; or for information concerning industrial, commercial or scientific experience. The term “royalties” also includes gains from the alienation of any property described above which are contingent on the productivity, use, or disposition of the property. Unlike the U.S. model, the proposed treaty specifically excludes from the definition of royalties payments for the right to use motion pictures or films, tapes, or other means of reproduction for use in radio or television broadcasting. Under the proposed treaty, such payments are specifically treated as business profits (Article 7). Such amounts are taxable by the source-country on a net basis if such payments are attributable to a permanent establishment.

Unlike the U.S. model, the proposed treaty does not include an explicit reference to computer software in the definition of royalties. The Technical Explanation states that consideration for the use of software is treated as royalties or business profits, depending on the facts and circumstances of the transaction. In this regard, the Technical Explanation further states that it is understood that payments for transfers of "shrink-wrap" computer software constitute business profits rather than royalties.

The exemption under the proposed treaty does not apply where the beneficial owner carries on business through a permanent establishment (or a fixed base, in the case of an individual who performs independent personal services) in the source-country and the royalties are attributable to the permanent establishment (or fixed base). In that event, such royalties are taxed as business profits (Article 7) or income from the performance of personal services (Article 14). In addition, royalties attributable to a permanent establishment or fixed base, but received after the permanent establishment or fixed base is no longer in existence, are taxable in the country where the permanent establishment or fixed base existed (Article 28, paragraph 3).

The proposed treaty addresses the issue of non-arm's-length royalties between related parties (or parties having an otherwise special relationship) by stating 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 royalty is taxable according to the laws of each country, taking into account the other provisions of the proposed treaty. For example, excess royalties paid to a parent corporation by its subsidiary may be treated as a dividend under local law and, thus, entitled to the benefits of Article 10 of the proposed treaty.

Article 13. Gains

Internal taxation rules

United States

Generally, gain realized by a nonresident alien individual 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. However, a nonresident alien individual 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 other than solely as a creditor (e.g., stock) in certain corporations that hold or held U.S. real property, provided that at least 50 percent of the fair market value of such corporation is (or was) attributable to U.S. real property interests.

Switzerland

Under Swiss law, gains from the sale of a capital asset by a foreign corporation may be taxed in the same manner as other business income. In addition, gains from the sale of Swiss real estate by a foreign individual may be subject to tax in Switzerland.

Proposed treaty limitations on internal law

Under the proposed treaty, gains derived by a resident of one country attributable to the alienation of real property situated in the other country may be taxed in the other country. Real property situated in the other country for purposes of this article includes real property referred to in Article 6 (Income from Real Property); shares or other comparable rights in a company resident in the other country, the assets of which consist wholly or principally of real property in such other country; and an interest in a partnership, trust, or estate, to the extent attributable to real property situated in such other state. The proposed treaty specifies that real property includes a United States real property interest, as defined under the Code (as it may be amended from time to time without changing the general principles thereof). The Technical Explanation states that distributions by a REIT that are attributable to gains derived from a disposition of real property are taxable under this article (and are not taxable under the dividends article (Article 10)).

The proposed treaty contains a standard provision which permits a country to tax the gain from the alienation of movable property that forms part of the business property of a permanent establishment located in that country or that pertains to a fixed base in that country. This rule also applies to gains from the alienation of such a permanent establishment or such a fixed base. The proposed treaty generally does not permit the United States to tax gains from the disposition of any movable property after such property ceases to be used in a U.S. trade or business. However, gains attributable to a permanent establishment or a fixed base, but received after the permanent establishment or fixed base is no longer in existence, are taxable in the country where the permanent establishment or fixed base existed (Article 28, paragraph 3).

The proposed treaty provides that gains of an enterprise of one of the treaty countries from the alienation of ships or aircraft operated in international traffic are taxable only in that country. This rule applies even if such gain is attributable to a permanent establishment in the other country. Unlike under the U.S. model, this exemption under the proposed treaty does not apply to gain from the alienation of containers used in international traffic. The proposed treaty further provides that gains described in the royalties article (Article 12) are taxable only in accordance with that article.

The proposed treaty provides that gains from the alienation of any property other than that discussed above are taxable under the proposed treaty only in the country of residence.

The proposed treaty provides authority for the competent authorities to coordinate the two countries' rules regarding the nonrecognition of income upon a corporate organization, reorganization, merger, or similar transaction. Where a resident of one country alienates property in such a transaction and does not recognize income on such transaction for purposes of such country's tax, the competent authority of the other country, if requested by the acquiror of such property, may agree to defer recognition of income for purposes of the other country's tax. Any such deferral would be for such time and subject to such terms and conditions as may be stipulated in the agreement. The Technical Explanation states that whether any deferral is granted by the competent authority is entirely within the discretion of the competent authority.

The proposed treaty provides an additional rule regarding the coordination of the timing of income recognition under the two tax systems. This rule applies if a resident of one country who is subject to tax in both countries on a disposition of property is taxable currently on such disposition in one country but not the other country. In such a case, the resident may elect to be taxed in the country that would otherwise allow deferral as if he or she had sold and repurchased the property, immediately before the disposition, for an amount equal to its fair market value. Such an election will apply for the taxable year in which made and any time thereafter.

Article 14. Independent Personal Services

Internal taxation rules

United States

The United States taxes the income of a nonresident alien at the regular graduated rates if the income is effectively connected with the conduct of a trade or business in the United States by the individual. The performance of personal services within the United States may constitute the conduct of a trade or business within the United States.

Under the Code, the income of a nonresident alien from the performance of personal services in 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: (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.

Switzerland

Nonresident alien individuals generally are subject to Swiss tax on income derived from Swiss sources. Nonresidents may be subject to Swiss withholding tax on employment income and, in the case of artists and athletes, income earned from activities performed in Switzerland.

Proposed treaty limitations on internal law

The proposed treaty limits the right of each country to tax income from the performance of personal services by a resident of the other country. Under the proposed treaty (unlike the present treaty), income from the performance of independent personal services (i.e., services performed as an independent contractor, not as an employee) is treated separately from income from the performance of dependent personal services.

Under the proposed treaty, like under the U.S. model, income from the performance of independent personal services by a resident of one country is exempt from tax in the other country unless the individual performing the services has a fixed base regularly available to him or her in the second country for the purpose of performing the activities. In that case, the nonresidence country may tax only that portion of the individual's income which is attributable to the fixed base in such country and that is derived in respect of services performed in such country. In contrast to the rules applicable to business profits, income from independent personal services is taxable in the country in which the fixed base is located only if such income is derived from services performed in such country.

The proposed treaty provides that amounts attributable to a fixed base, but received or incurred after the fixed base is no longer in existence, may nevertheless be taken into account in the country in which the fixed base was located (Article 28, paragraph 3).

Under the proposed treaty, in determining taxable independent personal services income, the principles of Article 7 (Business Profits) are applicable. According to the Technical Explanation, the taxpayer may deduct all relevant expenses, wherever incurred, in computing the net income from independent personal services subject to tax in the country in which the fixed base is located.

Article 15. Dependent Personal Services

Under the proposed treaty, wages, salaries, and other similar remuneration derived from services performed as an employee in one country (the source-country) by a resident of the other country are taxable only in the other country 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 beginning or ending during the taxable year concerned; (2) the individual's employer is not a resident of the source-country; and (3) the compensation is not borne by a permanent establishment or fixed base of the employer in the source-country. These limitations on source-country taxation generally are consistent with the U.S. and OECD models.

In this regard, the Memorandum of Understanding provides that this rule shall not preclude a country from withholding tax from such payments according to its domestic law. If, under this rule, the remuneration is taxable only in the residence country, the source country will make a refund of the withheld tax upon a duly filed claim. Such claims must be filed within five years after the close of the year of the withholding. This procedure is necessary because it may not be possible to know whether an employee will satisfy the requirements for an exemption from source-country tax until the close of the year.

The proposed treaty, like the U.S. model, provides that compensation derived from employment as a member of the regular complement of a ship or aircraft operated in international traffic is taxable only in the employee's country of residence.

Article 16. Directors' Fees

Under the proposed treaty, directors' fees and other similar payments derived by a resident of one country in his or her capacity as a member of the board of directors of a company which is a resident of the other country may be taxed in that other country. Under this rule, the country in which the company is resident may tax all of the remuneration paid to non-resident board members, regardless of where the services are performed. By contrast, under the U.S. model, the country in which the company is resident may tax only the portion of the non-resident board member's remuneration that is for services performed in such country.

Article 17. Artistes and Sportsmen

Like the U.S. and OECD models, the proposed treaty contains rules that apply to the taxation of income earned by entertainers (such as theater, motion picture, radio, or television "artistes," or musicians) and sportsmen. These rules apply notwithstanding the other provisions dealing with the taxation of income from personal services (Articles 14 and 15) and business profits (Article 7), and are intended, in part, to prevent entertainers and sportsmen from using the proposed treaty to avoid paying any tax on their income earned in one of the countries.

Under this article of the proposed treaty, one country may tax an entertainer or sportsman who is a resident of the other country on the income from his or her personal activities as such exercised in the first country during any year in which the gross receipts derived by him or her from such activities, including reimbursed expenses, exceed $10,000 or its Swiss franc equivalent. The threshold specified in the U.S. model is $20,000.

Under the proposed treaty, if a Swiss entertainer maintained no fixed base in the United States and performed (as an independent contractor) for one day of a taxable year in the United States for gross receipts of $2,000, the United States could not tax that income. If, however, that entertainer's gross receipts were $30,000, the full $30,000 (less appropriate deductions) would be subject to U.S. tax. This provision does not bar the country of residence from also taxing that income (subject to a foreign tax credit). (See Article 23 (Relief from Double Taxation.))

The Memorandum of Understanding clarifies that because it is not possible to know whether the $10,000 (or the Swiss franc equivalent) is exceeded until the end of the year, the source-country may subject all payments to an entertainer or sportsman to withholding and refund any excess amount withheld upon a duly filed claim. Such claim must be filed within five years.

According to the Technical Explanation, this article applies to all income directly connected with a performance by an entertainer or sportsman, such as appearance fees, award or prize money, and a share of the gate receipts. Income derived by an entertainer or sportsman from other than actual performance, such as royalties from record sales and payments for product endorsements, is not covered by this article; instead, these amounts are covered by other articles of the proposed treaty, such as Article 12 (Royalties) or Article 14 (Independent Personal Services). For example, if a Swiss entertainer receives royalty income from the sale of recordings of a concert given in the United States, the royalty income will be exempt from U.S. withholding tax under Article 12, even if the remuneration from the concert itself may have been covered by this article.

The proposed treaty provides that where income in respect of activities exercised by an entertainer or sportsman in his or her capacity as such accrues not to the entertainer or sportsman but to another person, that income may be taxed by the country in which the activities are exercised, unless it is established that neither the entertainer or sportsman nor persons related to him or her participate directly or indirectly in the profits of that other person in any manner, including the receipt of deferred remuneration, bonuses, fees, dividends, partnership distributions or other distributions. (This provision applies notwithstanding the business profits and independent personal service articles (Articles 7 and 14).) This provision prevents certain entertainers and sportsmen 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 18. Pensions and Annuities

Under the proposed treaty, pensions and other similar remuneration beneficially derived by a resident of either country in consideration of past employment generally are subject to tax only in the recipient's country of residence. This rule is subject to the provisions of Article 19 (Government Service and Social Security). Thus, for example, it generally does not apply to pensions paid to a resident of one treaty country attributable to services performed for government entities of the other country. The Technical Explanation states that it is understood that this provision will apply to both periodic and lump sum payments. The present treaty similarly provides for exclusive residence-country tax with respect to pensions, but defines "pension" to include only periodic payments. The Technical Explanation states that this provision covers amounts paid by all private retirement plans and arrangements in consideration of past employment, regardless of whether they are considered qualified plans under the Code. The Technical Explanation further states that this provision covers individual retirement accounts.

The proposed treaty provides that annuities may be taxed only in the country of residence of the person who derives and beneficially owns them. An annuity is defined as a stated sum payable periodically at stated times during a specified number of years or for life, under an obligation to make the payments in return for adequate and full consideration (other than services rendered). The present treaty similarly provides exclusive residence-country taxation for annuities. The U.S. model defines "annuity" to include only amounts paid during a specified number of years and not amounts paid for life.

Article 19. Government Service and Social Security

Under the proposed treaty, remuneration, other than a pension, paid by a country or one of its political subdivisions or local authorities to an individual for services rendered to the payor generally is taxable in that country only. However, such remuneration is taxable only in the other country (the country that is not the payor) if the services are rendered in that other country and the individual is a resident of that other country who either is a national of that other country or did not become a resident of that country solely for the purpose of rendering the services. Thus, for example, Switzerland will not tax the compensation of a U.S. citizen and resident who is in Switzerland to perform services for the U.S. Government, and the United States will not tax the compensation of a Swiss citizen and resident who performs services for the U.S. Government in Switzerland.

Any pension paid by a country, or one of its political subdivisions or local authorities, to an individual for services rendered to the payor generally is taxable only in that country. However, such pensions are taxable only in the other country if the individual is both a resident and a national of that other country.

These rules regarding government remuneration and pensions are exceptions to the saving clause, pursuant to Article 1, paragraph 3(b) of the proposed treaty. Consequently, the saving clause does not apply to benefits conferred by this article to an individual who is neither a U.S. citizen nor a U.S. green-card holder. Thus, for example, the United States would not tax the compensation of a Swiss citizen who is not a U.S. green-card holder but who resides in the United States to perform services for the Swiss Government.

If a country or one of its political subdivisions or local authorities is carrying on a business (as opposed to functions of a governmental nature), the provisions of Articles 15 (Dependent Personal Services), 16 (Directors' Fees), and 18 (Pensions and Annuities) will apply to remuneration and pensions for services rendered in connection with such business.

Under the proposed treaty, social security payments and other public pensions paid by one country to an individual resident in the other country may be taxed in the residence country. [11] In addition, such payments may be taxed in the source-country according to the laws of such country, but such tax may not exceed 15 percent of the gross amount of the payment. In contrast, the U.S. model provides that social security payments may be taxed only in the source-country. The Technical Explanation states that the deviation from the U.S. model is necessary in this case to mitigate the double taxation of Swiss residents receiving U.S. social security benefits that arises under the two countries' tax regimes applicable to such amounts.

Article 20. Students and Trainees

The treatment provided to students and trainees under the proposed treaty corresponds generally to the treatment provided under the present treaty.

Under the proposed treaty, a student, apprentice, or business trainee who visits the other country (the host country) for the purpose of full-time education or training, and who immediately before

[11] The proposed protocol provides that the term "other public pensions" is intended to refer to United States tier 1 Railroad Retirement benefits.

that visit is or was a resident of the other treaty country, is exempt from tax in the host country on payments that he or she receives for the purpose of maintenance, education, or training provided that such payments arise from sources outside the host country. Under the U.S. model, the corresponding exemption for students and trainees is available only for a period of one year from the date the individual first arrives in the host country for the purpose of training; the proposed treaty does not contain any time limitation on the availability of the exemption from host-country tax.

This article is an exception to the saving clause, pursuant to Article 1, paragraph 3(b) of the proposed treaty. Consequently, the saving clause does not apply to benefits conferred by this article to an individual who is neither a U.S. citizen nor a U.S. green-card holder. Thus, for example, the United States would not tax such amounts paid to a Swiss citizen who is not a U.S. green-card holder but who resides in the United States as a full-time student.

Article 21. 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 Switzerland. This article is substantially similar to the corresponding article in the U.S. model.

As a general rule, items of income of a resident of either country that are not otherwise dealt with in the proposed treaty are taxable only in the country of residence. This rule, for example, gives the United States the sole right under the treaty to tax income derived from sources in a third country and paid to a resident of the United States. This article is subject to the saving clause, so U.S. citizens who are Swiss residents would continue to be taxable by the United States on their third-country income, with a foreign tax credit provided for income taxes paid to Switzerland.

The general rule just stated does not apply to income if the person deriving the income is a resident of one country and carries on business in the other country through a permanent establishment or a fixed base and the right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such a case, the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, will apply. In addition, other income attributable to a permanent establishment or fixed base, but received after the permanent establishment or fixed base is no longer in existence, is taxable in the country where the permanent establishment or fixed base existed (Article 28, paragraph 7). An exception to this rule is provided for income from real property. Thus, for example, if a U.S. resident has a Swiss permanent establishment and the resident derives income from real property located in a third country that is effectively connected with the Swiss permanent establishment, under the proposed treaty, only the United States may tax such income.

Under the proposed treaty, the rule of exclusive residence-country tax provided in this article does not apply to income subject to tax in either country on wagering, gambling, or lottery winnings. Accordingly, each country may tax such winnings under its internal law. Under the U.S. model, such winnings are covered by the rule of exclusive residence-country tax.

Article 22. Limitation on Benefits

In general

The proposed treaty contains a provision generally intended to limit indirect use of the treaty by persons who are not entitled to its benefits by reason of residence in the United States or Switzerland, or in some cases, in another member country of the European Union or the European Economic Area, or in a party to NAFTA.

The proposed treaty is intended to limit double taxation caused by the interaction of the tax systems of the United States and Switzerland 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 country seeks certain benefits under the income tax treaty between the two countries. Under certain circumstances, and without appropriate safeguards, the nonresident may be able to secure these benefits indirectly by establishing a corporation (or other entity) in one of the countries, which entity, as a resident of that country, is entitled to the benefits of the treaty. Additionally, it may be possible for a third-country resident to reduce the income base of a treaty country resident by having the latter pay out interest, royalties, or other deductible amounts under favorable conditions either through relaxed tax provisions in the distributing country or by passing the funds through other treaty countries (essentially, continuing to treaty shop), until the funds can be repatriated under favorable terms.

Summary of proposed treaty provisions

The anti-treaty shopping article in the proposed treaty provides that a treaty country resident is entitled to treaty benefits in the other country only if it falls within one of several specified categories. This provision of the proposed treaty is in some ways comparable to the U.S. Treasury regulation under the branch tax definition of a qualified resident.[12] However, the proposed treaty provides opportunities for treaty benefit eligibility which are not provided under that regulation.

Generally, a resident of either country qualifies for the benefits accorded by the proposed treaty if such resident falls within one of the following categories:

(1) An individual;
(2) A government;
(3) An entity that satisfies an active business test with respect to a particular item of income;
(4) An entity that satisfies a headquarters company test;
(5) A company that satisfies a public company test;
(6) A company, trust or estate that satisfies a predominant interest test;
(7) A qualified family foundation; or

[12] Treas. Reg. sec. 1.884–5.

(8) A qualified pension trust or non-profit organization.

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 the derivative benefits test. Special rules apply to income derived by a resident of Switzerland in certain "triangular" cases described below. Finally, a treaty country resident is entitled to treaty benefits if the resident is otherwise approved by the source-country's competent authority, in the exercise of the latter's discretion.

The proposed treaty provides that the competent authorities are to consult with a view to developing a commonly agreed application of these provisions. Subject to the limitations in the information exchange article, the competent authorities may exchange such information as is necessary for carrying out these provisions.

Individuals

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

Governments

Under the proposed treaty, the two countries, political subdivisions and local authorities thereof, and agencies or instrumentalities of such countries, subdivisions or authorities are entitled to all treaty benefits. The definition of the term "government" contained in the Memorandum of Understanding for purposes of determining the country of residence is broader than this concept. This concept does not include, for example, pension trusts for current and former employees of a country or political subdivision.

Entities satisfying active trade or business test

In general

Under the active business test, treaty benefits in the source-country are available under the proposed treaty to an entity that is a resident of one treaty country if it is engaged in the active conduct of a trade or business in the residence country and the income derived from the source-country is derived in connection with, or is incidental to, that trade or business. The proposed protocol adds a further requirement in the case of payments between related parties: such a payment is treated as derived in connection with a trade or business only if the trade or business carried on in the residence country is substantial in relation to the income-producing activity carried on in the source-country.

This active business test is applied separately to each item of income. Accordingly, an entity may be eligible for treaty benefits with respect to some but not all of the income derived in the source-country. In contrast, satisfaction of the requirements for any one of the other specified categories allows treaty benefits for all income derived from the source-country.

Trade or business

Under the proposed treaty, the active business test is applied by disregarding the business of making, managing, or holding investments for the entity's own account, unless these activities are banking, insurance or securities activities carried on by a bank, insurance company, or registered securities dealer, respectively. The Memorandum of Understanding clarifies that this rule does not affect the status of investment advisors or others that actively conduct the business of managing investments beneficially owned by others.

The proposed protocol provides that the determination whether activities constitute an active trade or business must be made under all the facts and circumstances. However, it further provides that a trade or business generally comprises activities that constitute an independent economic enterprise carried on for profit. In order to constitute a trade or business, a resident's activities ordinarily must include every operation that is a part of, or a step in, a process by which an enterprise may earn income or profit. A resident is considered to actively conduct a trade or business if it regularly performs active and substantial management and operational functions through its own officers or employees. Although some of such activities may be carried out by independent contractors under the direct control of the resident, the activities of such independent contractors are disregarded in determining whether the resident actively conducts a trade or business.

The Memorandum of Understanding clarifies that the active conduct of a trade or business may involve the performance of services as well as manufacturing or sales activities. The Memorandum of Understanding further clarifies that the resident itself may be actively conducting a trade or business or it may be deemed to be so engaged through the activities of related persons that are residents of one of the countries.

Income derived in connection with a trade or business

Under the proposed treaty, the income eligible for treaty benefits under this active business test is the income derived from the source-country in connection with, or incidental to, the active conduct of a trade or business in the residence country. The Memorandum of Understanding clarifies that income is considered derived in connection with an active trade or business in a country if the income-producing activity in the other country is a line of business which is part of or is complementary to the trade or business conducted in the first country. The line of business in the first country may be upstream, downstream or parallel to the income-producing activity in the other country. The Technical Explanation states that it is intended that a business activity in the source-country will be considered to form a part of a business activity 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 Technical Explanation further states that two activities will be considered complementary if they are part of the same overall industry and the success or failure of the two are interrelated. According to the Technical Explanation, where more than one business is conducted in the source-country and only one of such businesses forms a part of or is complementary to a business conducted in the residence country, the income attributable to that particular business must be determined for purposes of applying this test.

The Memorandum of Understanding clarifies that income is considered to be incidental to the trade or business carried on in the other country if the production of such income facilitates the conduct of such trade or business. For example, interest income earned from the short-term investment of working capital would be considered to be incidental income.

Substantiality requirement for related party payments

Under the proposed protocol, a payment between related parties is treated as derived in connection with a trade or business only if the trade or business carried on in the residence country is substantial in relation to the income-producing activity carried on in the other country. For this purpose, the income recipient is related to the income payor if it owns, directly or indirectly, at least 10 percent of the shares or other comparable rights in the payor.

The proposed protocol further provides that "substantiality" will be determined based on all the facts and circumstances, taking into account the following factors: the comparative sizes of the businesses in each country (measured based on asset values, income and payroll expenses), the nature of the activities in each country, and, in cases where a business is conducted in both countries, the relative contributions to such business in each country. In making a determination or comparison, due regard is to be given to the relative sizes of the Swiss and U.S. economies.

The Memorandum of Understanding clarifies that this substantiality requirement is intended to prevent treaty-shopping abuses involving the attempt to qualify for treaty benefits by engaging in de minimis business activities in the source-country that have little economic cost or effect with respect to the business as a whole.

Headquarters companies

Under the proposed treaty, entities that are recognized headquarters companies for multinational corporate groups are eligible for treaty benefits. The Technical Explanation states that the headquarters company need not own shares in the companies it supervises. For this purpose, an entity is a recognized corporate headquarters company if it meets the following seven requirements.

First, the company must provide in its residence country a substantial portion of the overall supervision and administration of a group of companies. Such activities may include group financing, but such financing cannot be the principal activity. The group of companies so supervised and administered may be part of a larger multinational corporate group. Moreover, the Technical Explanation states that the supervised group is not required to include companies resident in the other country.

According to the Technical Explanation, while other activities could be part of the supervision and administration function, a company will be considered to engage in supervision and administration only if it engages in some of the following activities: group financing, pricing, marketing, internal auditing, internal communications, and management. The Technical Explanation further states that a company will satisfy the requirement that it perform a substantial portion of the overall supervision and administration of a group only if its supervision and administration activities are substantial in relation to such activities performed for the same group by other entities. However, the standard for "substantial " is not specified.

Second, the group of companies must include corporations resident in and engaged in business in at least five countries and the business activities carried on in each of the five countries (or five groupings of countries) must generate at least 10 percent of the gross income of the group. For purposes of this rule, income from multiple countries may be aggregated as long as there are at least five individual countries or groupings that each satisfy the 10-percent requirement. If this requirement is not satisfied for a particular year, it will be deemed to be satisfied if it is met based on an averaging of the gross income of the preceding four years.

Third, the business activities carried on in any single country other than the headquarters company's country of residence must generate less than 50 percent of the group's gross income. If this requirement is not satisfied for a particular year, it will be deemed to be satisfied if it is met based on an averaging of the gross income of the preceding four years.

Fourth, no more than 25 percent of the company's gross income may be derived from the other country. If this requirement is not satisfied for a particular year, it will be deemed to be satisfied if it is met based on an averaging of the gross income of the preceding four years.

Fifth, the company must have and exercise independent discretionary authority to carry out the overall supervision and administration functions. The Technical Explanation states that this determination is made separately for each function.

Sixth, the company must be subject to generally applicable tax rules in its residence country. The Technical Explanation states that this requirement should be understood to mean that the company must be subject to the tax rules applicable to a company engaged in the active conduct of a trade or business. Accordingly, the Technical Explanation states that if the company is subject to special tax rules applicable to headquarters companies, it would not be considered to be a recognized headquarters company.

Seventh, the income derived in the other country must be derived in connection with, or must be incidental to, the business activities conducted in other countries. The Technical Explanation states that this determination is made under the principles set forth with respect to the active business test.

Public companies

Under the proposed treaty, a company is entitled to treaty benefits if sufficient shares in the company are traded actively enough on a suitable stock exchange. This rule is similar to the branch profits tax rules in the Code under which a company is entitled to treaty protection from the branch tax if it meets such a test or if it is the wholly-owned subsidiary of certain publicly traded corporations resident in a treaty country.

Publicly traded companies

A company that is a resident of Switzerland or the United States is entitled to treaty benefits if the principal class of its shares is primarily and regularly traded on a recognized stock exchange. Thus, such a company is entitled to the benefits of the treaty regardless of where its actual owners reside.

The term "recognized stock exchange" means any Swiss stock exchange on which regular dealings in shares take place; any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for the purposes of the Securities Exchange Act of 1934; the NASDAQ System owned by the National Association of Securities Dealers; the stock exchanges of Amsterdam, Frankfurt, London, Milan, Madrid, Paris, Tokyo and Vienna; and any other stock exchange agreed upon by the competent authorities of the two countries.

The term "principal class of shares" is not defined in the proposed treaty. However, the Technical Explanation states it will be interpreted by the United States to mean the class of shares that represents the majority of the voting power and value of the company. If no single class of shares accounts for more than half of the company's voting power and value, then this test will be applied with respect to a group of two or more classes of the company's shares that accounts for more than half of the company's voting power and value. In this regard, it is necessary only that one such group be primarily and regularly traded on a recognized stock exchange.

The term "regularly traded" also is not defined in the proposed treaty. This term therefore is defined by reference to the domestic laws of the country from which benefits are being sought. The Technical Explanation states that, in the case of the United States, the term is understood to have the meaning it has under U.S. internal law: trades in the class of shares must be made in more than de minimis quantities on at least 60 days during the taxable year and the average number of shares traded during the year must be at least 10 percent of the average number of shares outstanding.

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

Subsidiaries of publicly traded companies

A company that is a resident of Switzerland or the United States is entitled to treaty benefits if the ultimate beneficial owners of a predominant interest in such company are one or more companies, the principal classes of the shares of which are traded as described above. The Technical Explanation states that this predominant interest requirement will be interpreted consistently with the predominant interest test described below. This generally requires a direct or indirect interest of more than 50 percent. The Memorandum of Understanding clarifies that a subsidiary that qualifies under this rule must be a subsidiary of a resident of one of the countries.

Entities satisfying predominant interest test

Under the proposed treaty, a company, trust, or estate that is resident in one of the countries is entitled to treaty benefits unless one or more persons who are not entitled to benefits are, in the aggregate, the ultimate beneficial owners of a predominant interest, in the form of a participation or otherwise, in such entity. The proposed protocol provides that for this purpose the countries will take into account not only equity interests that such persons have in the entity but also other contractual interests such persons have in the entity and the extent to which such persons receive (or have the right to receive) directly or indirectly payments from such entity that reduce the amount of the taxable income of such entity. The payments referred to include interest and royalties but not arm's-length payments for services or for the purchase or use of, or right to use, tangible property in the ordinary course of business. These payments and interests other than equity interests are taken into account only to deny benefits to an entity that would otherwise qualify under this predominant interest test when equity interests only are taken into account.

The Technical Explanation states that a predominant interest is a direct or indirect interest of more than 50 percent. If the persons not entitled to treaty benefits own a predominant interest in the equity of the entity, the entity is *not* entitled to treaty benefits. Only if persons not entitled to treaty benefits do not own a predominant interest in the equity of the entity is an inquiry made into the ownership of payments and interests other than equity.

The Memorandum of Understanding includes a series of examples illustrating the application of this test.

Swiss family foundations

Under the proposed treaty, a family foundation resident in Switzerland is entitled to treaty benefits, unless (1) the founder or the majority of the beneficiaries are not individuals resident in one of the treaty countries or (2) 50 percent or more of the foundation's income could benefit persons who are not individuals resident in one of the treaty countries. The Technical Explanation states that a family foundation that distributes all its income to U.S. and Swiss residents would not qualify under this rule if there is no restriction that would prevent the possibility of a distribution to other non-qualifying persons.

Tax-exempt organizations

Under the proposed treaty, an entity is entitled to treaty benefits if it is a pension trust or nonprofit organization resident in one of the countries provided that more than half the beneficiaries, members, or participants, if any, in the organization are persons entitled to benefits under the proposed treaty (other than under the active business or tax-exempt organizations tests). This rule applies to organizations maintained exclusively to administer or provide pensions, retirement or employee benefits and established by or sponsored by a resident of such country and to not-for-profit organizations established and maintained for religious, charitable, educational, scientific, cultural or other public purposes, provided that such organization by reason of its nature as such generally is tax-exempt in its residence country.

Derivative benefits rule

The proposed treaty contains a reciprocal derivative benefits rule. This rule effectively allows a Swiss 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 countries will be entitled to the benefits of the proposed treaty under the dividends, interest, and royalties articles.

First, the company must satisfy an ownership test. Under this test, the ultimate beneficial owners of more than 30 percent of the aggregate vote and value of all the company's shares must be persons that are resident in that country and that are entitled to benefits under the proposed treaty (other than under the active business or tax-exempt organizations tests). The Technical Explanation states that only direct ownership is taken into account for purposes of this test.

Second, the company must satisfy a derivative benefits test. Under this test, the ultimate beneficial owners of more than 70 percent of the aggregate vote and value of all of the company's shares must be persons that either qualify under the ownership test or are qualifying persons that are residents of member states of the European Union or the European Economic Area or parties to NAFTA. For this purpose, a person is a qualifying person only if the person (1) is a resident of a country with which the other country has a comprehensive income tax treaty and is entitled to all the benefits of such treaty; (2) would qualify for benefits (other than under the active business or tax-exempt organizations tests) if the person were a resident of the first treaty country; and (3) would be entitled to a rate of tax in the other country under a treaty between such country and the person's country of residence that is at least as low as the rate applicable under the proposed treaty.

Third, the company must satisfy a base reduction test. Under this test, the deductible expenses paid or payable by the company for its preceding fiscal period to persons that do not qualify for treaty benefits must be less than 50 percent of the company's gross income for the period. If the company's first fiscal period is at issue, this test is applied based on the current fiscal period. The term "gross income" is not defined. The Technical Explanation states that, in the case of the United States, the term will be defined as gross receipts less cost of goods sold.

Triangular cases

Under present laws and treaties that apply to Swiss residents, it is possible for profits of a permanent establishment maintained by a Swiss resident in a third country to be subject to a very low aggregate rate of Swiss and third-country income tax. The proposed treaty, in turn, eliminates the U.S. tax on several specified types of income of a Swiss resident. In a case where the U.S. income is earned by a third-country permanent establishment of a Swiss resident (the so-called "triangular case") the proposed treaty could have the potential of helping Swiss residents to avoid all (or substantially all) taxation, rather than merely avoiding double taxation.

The Technical Explanation provides that although the proposed treaty is drafted reciprocally with respect to this issue, these rules have no application to the United States because the United States does not exempt the profits of a U.S. company attributable to its third-country permanent establishment.

The proposed treaty includes a special rule designed to prevent the proposed treaty from reducing or eliminating U.S. tax on income of a Swiss resident in a case where no other substantial tax is imposed on that income. Under the special rule, the United States is permitted to tax dividends, interest, and royalties paid to the third-country permanent establishment at the rate of 15 percent. In addition, under the special rule, the United States is permitted to tax other types of income without regard to the treaty.

In order for the special rule to apply, three conditions must be satisfied. First, a Swiss enterprise must derive income from the United States. Second, such income must be attributable to a permanent establishment that the Swiss enterprise has in a third country. Third, the combined Swiss and third-country taxation of the item of U.S.-source income earned by the Swiss enterprise with the third-country permanent establishment must be less than 60 percent of the Swiss tax that would be imposed if the income were earned by the same enterprise in Switzerland and were not attributable to the permanent establishment.

The special rule does not apply to royalties received as compensation for the use of, or the right to use, intangible property produced or developed by the third-country permanent establishment. The special rule also does not apply if the U.S.-source income is derived in connection with, or is incidental to, the active conduct of a trade or business carried on by the permanent establishment in the third country (other than the business of making, managing or holding investments for the person's own account unless these activities are banking, insurance or securities activities carried on by a bank, insurance company or registered securities dealer, respectively).

Grant of treaty benefits by the competent authority

Finally, the proposed treaty provides a "safety-valve" for a treaty country resident that has not established that it meets one of the other more objective tests. Under this provision, such a person may be granted treaty benefits if the competent authority of the source-country so determines after consultation with the competent authority of the other country.

The Technical Explanation states that the competent authority of a country will base its determination on whether the establishment, acquisition, or maintenance of the person seeking benefits under the proposed treaty, or the conduct of such person's operations, has or had as one of its principal purposes the obtaining of benefits under the treaty. Thus, persons that establish operations in either the United States or Switzerland with the principal purposes of obtaining benefits under the proposed treaty ordinarily will not be granted such benefits. The Technical Explanation also states that the competent authorities may determine to grant all, or partial, benefits of the treaty.

This provision of the proposed treaty is similar to a portion of the qualified resident definition under the Code branch tax rules, under which the Secretary of the Treasury may, in his sole discretion, treat a foreign corporation as a qualified resident of a foreign country if the corporation establishes to the satisfaction of the Secretary that it meets such requirements as the Secretary may establish to ensure that individuals who are not residents of the foreign country do not use the treaty between the foreign country and the United States in a manner inconsistent with the purposes of the Code rule (sec. 884(d)(4)(D)).

The Memorandum of Understanding sets forth the understanding that certain companies will be granted treaty benefits. This understanding applies to a company resident in one of the countries if two requirements are met. First, the ultimate beneficial owners of at least 95 percent of the voting power and value of all its shares must be seven or fewer persons that are residents of a member state of the European Union or the European Economic Area or a party to NAFTA that meet the requirements for the derivative benefits rule. Second, the company's deductible expenses paid or payable for its preceding fiscal year to persons that are not residents of a member state of the European Union or the European Economic Area or a party to NAFTA that qualify under the derivative benefits must be less than 50 percent of the company's gross income for the period.

However, the Memorandum of Understanding further provides that a company otherwise entitled to benefits pursuant to this understanding will be denied benefits if the company, or a company that controls such company, has outstanding a "disproportionate" class of shares that is more than 50-percent (by vote or value) owned by persons that are neither U.S. citizens nor residents of a member state of the European Union or the European Economic Area or a party to NAFTA that qualify under the derivative benefits rule. A disproportionate class of shares is one with terms or other arrangements that entitle the holders to a portion of the income derived from the other country that is greater than the portion such holders would receive absent such terms or arrangements.

Article 23. Relief from Double Taxation

Internal taxation rules

United States

One of the two 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. The United States seeks unilaterally to mitigate double taxation by generally allowing U.S. 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 receives a dividend from 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 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.

Switzerland

Under Swiss law, relief from double taxation generally is provided under one of two methods. Under the exemption with progression method, foreign-source income generally is exempt from Swiss tax but is taken into account in determining the Swiss tax rates applicable to other income. Under the deduction approach, the foreign tax is deducted as an expense and only the net foreign-source income is subject to Swiss tax. The deduction method generally applies to dividends, interest and royalties.

Proposed treaty rules

Overview

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 is engaged in business in both countries. Also, a corporation or individual may be treated as a resident of more than one country and may be taxed on a worldwide basis by both.

The double tax issue is addressed in part 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 Switzerland and the United States would otherwise still tax the same item of income. This article is not subject to the saving clause, so that the United States waives 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 Switzerland. 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 Switzerland. The determination of this credit is made in accordance with U.S. law. The present treaty generally provides for relief from double taxation of Swiss residents by requiring Switzerland to provide, in accordance with Swiss law, an exclusion for the items of U.S.-source income that are not exempt from, nor entitled to a reduced rate of, U.S. tax pursuant to the treaty. In the case of a U.S. citizen resident in Switzerland, such exclusion applies to all U.S.-source income. However, Switzerland reserves the right to take income excluded under these rules into account in determining the rate of Swiss tax applicable to other income.

Proposed treaty limitations on Swiss internal law

Under the proposed treaty, the relief rules applicable in the case of Switzerland depend upon the particular type of income that is subject to U.S. tax. In general, the proposed treaty requires Switzerland to exempt from its internal tax income derived by a Swiss resident that is subject to U.S. tax under the proposed treaty. However, gains from U.S. real property will be eligible for this exemption only if the Swiss resident demonstrates that such gains are subject to actual tax in the United States. Moreover, as under the present treaty, Switzerland may employ its "exemption with progression" method with respect to the income taxed in the United States; under this method, the exempt income is taken into account for purposes of determining the rate of Swiss tax applicable to the remainder of the resident's income.

In the case of dividends that are derived by a Swiss resident and that are taxable under Article 10 of the proposed treaty, the proposed treaty provides that Switzerland will provide relief from its tax upon request. This relief may take the form of (1) a deduction from the Swiss tax on such dividends for an amount equal to the U.S. tax imposed in accordance with Article 10 (Dividends), provided that such deduction will not exceed the pre-relief portion of the Swiss tax with respect to the income taxed in the United States, (2) a lump sum reduction of the Swiss tax, or (3) a partial exemption from the Swiss tax on such dividends, representing at least the deduction of the U.S. tax from the gross amount of the dividends. The applicable relief and procedures are determined in accordance with Swiss law.

In the case of income derived by a Swiss resident that represents REIT dividends not eligible for a reduction in U.S. tax, contingent interest and excess inclusions with respect to a residual interest in a REMIC not eligible for a reduction in U.S. tax, and other income taxed in the United States because it does not qualify for treaty benefits under Article 22 (Limitation on Benefits), Switzerland allows a deduction of the U.S. tax from the gross amount of such income.

In the case of U.S. social security benefits and other public pensions derived by a Swiss resident and subject to U.S. tax, Switzerland will allow a deduction from Swiss taxable income for an amount equal to the U.S. tax, plus an exemption from Swiss tax for one-third of the net amount of such payment. This rule, together with the rules of Article 19 (Government Service and Social Security), are designed to provide relief from the double taxation of such U.S. benefits of a Swiss resident.

Proposed treaty limitations 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 taxes imposed by Switzerland. The proposed treaty also requires the United States to allow a deemed-paid credit, with respect to Swiss tax, to any U.S. corporate shareholder of a Swiss company that receives dividends from such company if the U.S. company owns 10 percent or more of the voting stock of the Swiss company.

The credit generally is to be computed in accordance with the provisions and subject to the limitations of U.S. law (as those provisions and limitations may change from time to time without changing the general principle of this credit provision). This provision is similar to those found in the U.S. model and many other U.S. income tax treaties.

For purposes of applying the U.S. foreign tax credit rules, Swiss taxes covered by the proposed treaty (Article 2 (Taxes Covered)) are considered to be income taxes.

The proposed treaty, like the U.S. model and other U.S. treaties, contains a special rule designed to provide relief from double taxation for U.S. citizens who are Swiss residents. Under this rule, Switzerland will apply the foreign tax credit relief provisions to a U.S. citizen who is resident in Switzerland as if the person were not a U.S. citizen (i.e., by taking into account only the amount of U.S. taxes that would be paid if he or she were not a U.S. citizen with respect to items of income that, under the proposed treaty, are either exempt from U.S. tax or are subject to a reduced rate of tax when derived by a Swiss resident who is not a U.S. citizen). The United States will then credit the income tax actually paid to Switzerland. The proposed treaty recharacterizes the income that is subject to Swiss taxation as foreign-source income for purposes of this computation. The result of this computation is that the ultimate U.S. tax liability of a U.S. citizen who is a Swiss resident, with respect to an item of income, should not be less than the tax that would be paid if the individual were a Swiss resident and not a U.S. citizen.

Article 24. Non-Discrimination

The proposed treaty contains a comprehensive nondiscrimination article relating to all taxes of every kind imposed at the national, state, or local level. It is similar to the nondiscrimination articles in the U.S. model and other recent U.S. income tax treaties. It is broader than the nondiscrimination provision of the present treaty.

In general, under the proposed treaty, one country cannot discriminate by imposing other or more burdensome taxes (or requirements connected with taxes) on nationals of the other country than it would impose on its nationals in the same circumstances. This provision applies whether or not the nationals in question are residents of the United States or Switzerland. A U.S. national who is not a resident of the United States and a Swiss national who is not a resident of the United States are not considered to be in the same circumstances for U.S. tax purposes.

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 enterprise or resident carrying on the same activities. However, the proposed treaty further provides that nothing is this article will be construed as preventing the United States from imposing a branch profits tax. Consistent with the U.S. and

OECD model treaties, a country is not obligated to grant residents of the other country any personal allowances, reliefs, or reductions for tax purposes on account of civil status or family responsibilities which it grants to its own residents.

Each country is required (subject to the arm's-length pricing rules of Articles 9 (Associated Enterprises), 11 (Interest), and 12 (Royalties)) to allow enterprises of such country 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 indicates 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 enterprises. Similarly, any debts of an enterprise that is a resident of either country to a resident of the other country must be deductible for the purposes of determining the taxable capital of the enterprise under the same conditions as if the debts had been contracted to a resident of the first country.

The nondiscrimination rule also applies under the proposed treaty 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 which is other or more burdensome than the taxation and connected requirements that the first country imposes or may impose on its similar enterprises.

U.S. internal law generally treats a corporation that distributes property to its shareholders as realizing gain or loss as if the property had been sold. A nonrecognition rule applies, however, to certain distributions of stock and securities of a controlled corporation. U.S. internal law also generally treats a corporation that distributes property in complete liquidation as realizing gain or loss as if the property had been sold to the distributee. If, however, 80 percent or more of the stock of the corporation is owned by another corporation, a nonrecognition rule applies and no gain or loss is recognized to the liquidating corporation. Special provisions make these nonrecognition provisions inapplicable if the distributee is a foreign corporation (Code sec. 367(e)(1) and (2)). The proposed protocol provides that nothing in this nondiscrimination article will prevent the United States from applying Code section 367(e)(1) or (2).

U.S. internal law generally requires a partnership that engages in a U.S. trade or business to pay a withholding tax attributable to a foreign partner's share of the effectively-connected income of the partnership. The withholding tax is not the final liability of the partner, but is a prepayment of tax which will be refunded to the extent it exceeds a partner's final U.S. tax liability. No withholding is required with respect to a U.S. partner's share of the effectively-connected income of the partnership. The proposed protocol provides that nothing in this nondiscrimination article will prevent the United States from applying section Code 1446.

The saving clause (which allows the United States to tax its citizens or residents notwithstanding certain treaty provisions) does not apply to the nondiscrimination article. Therefore, a U.S. citizen resident in Switzerland may claim benefits with respect to the United States under this article.

Article 25. Mutual Agreement Procedure

The proposed treaty contains the standard mutual agreement provision, with some variation, which authorizes the competent authorities of the United States and Switzerland 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 may result in a waiver (otherwise mandated by the proposed treaty) of U.S. taxing jurisdiction over its citizens or residents.

Under this article, a resident of one country, who considers that the actions of one or both of the countries result, or will result, for him or her in taxation not in accordance with the proposed treaty, may present the case to the competent authority of the country of which he or she is a resident or national. The competent authority will then make a determination as to whether the objection appears justified. If the objection appears to be justified and if the competent authority is not itself able to arrive at a satisfactory solution, then the competent authority will 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 Technical Explanation states that Swiss law does not permit competent authority relief if a request for relief is not made within the 10-year period after the final assessment of Swiss taxes; the Technical Explanation further states the United States will use such a 10-year period for accepting competent authority requests.

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. Like the U.S. model, the proposed treaty makes express provision for competent authorities to mutually agree on various issues, including the attribution of income, deductions, credits, or allowances to a permanent establishment of an enterprise of a treaty country; the allocation of income, deductions, credits, or allowances; the characterization of particular items of income; the characterization of persons; the application of source rules with respect to particular items of income; the common meaning of a term; the application of domestic law with respect to penalties, fines, and interest; and the elimination of double taxation in cases not provided for in the treaty. The proposed treaty does not specify, as does the U.S. model, that the competent authorities may agree on advance pricing arrangements and increases (where appropriate in light of economic or monetary developments) in the dollar thresholds in provisions such as the artistes and sportsmen article and the students and trainees articles.

The proposed treaty authorizes the competent authorities to communicate with each other directly for purposes of reaching an agreement. 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. Under the proposed treaty, the competent authorities also are authorized to prescribe procedures to carry out the purposes of the proposed treaty.

The proposed treaty contains a provision allowing for arbitration. If any difficulty arising as to the interpretation or application of the proposed treaty cannot be resolved by the competent authorities pursuant to the mutual agreement procedures, the case may be submitted to arbitration. This procedure applies only if both competent authorities and all affected taxpayers agree to it and the taxpayers agree in writing to be bound by the decision of the arbitration board. The decision of the arbitration board in a particular case will be binding on both countries with respect to such case. The proposed treaty provides that the procedures with respect to arbitration will be established in an exchange of notes between the two countries. The proposed treaty further provides that the provisions with respect to arbitration will take effect only after the two countries have so agreed through an exchange of notes.

Article 26. Exchange of Information

The proposed treaty provides for the exchange of information necessary to carry out the provisions of the proposed treaty or for the prevention of tax fraud or the like in relation to the taxes covered by the proposed treaty. The Technical Explanation states that the "necessary" standard requires only that the information be relevant and does not require that the requesting country demonstrate that it would be unable to enforce its tax laws without such information. This "relevant" standard is consistent with the parallel provision in the U.S. model.

Under the proposed treaty, information may be exchanged in connection with the enforcement of either country's domestic law only in the case of tax fraud. This means that, except for exchanges of information to carry out the provisions of the proposed treaty, information will only be exchanged in the case of tax fraud. Two special rules apply to exchanges of information in the case of tax fraud. First, the exchange of information is not restricted by Article 1 (Personal Scope). Therefore, third-country residents are covered by these exchange of information provisions (but only in cases of tax fraud). Second, where specifically requested by the competent authority of one country, the competent authority of the other country shall provide information in the form of authenticated copies of unedited original documents.

For purposes of this provision, the proposed protocol provides that "tax fraud" means fraudulent conduct that causes (or is intended to cause) an illegal and substantial reduction in the amount of tax paid to one of the countries. Fraudulent conduct will be assumed in cases where, for example, a taxpayer uses a forged or falsified document or a scheme of lies to deceive the tax authorities. The proposed protocol further provides that tax fraud may include acts that, at the time of a request for information, constitute fraudulent conduct with respect to which the requested country may obtain information under its laws or practice. In addition, the proposed protocol provides that, in determining whether tax fraud exists in a case involving the conduct of a profession or business, the requested country will treat the record-keeping laws of the requesting country as if they were its own requirements. This means, for example, that if the United States is contemplating making a request for information from Switzerland with respect to tax fraud involving a profession or business, Switzerland would have to apply U.S. recordkeeping requirements (instead of Swiss recordkeeping requirements) in determining whether tax fraud existed. The Memorandum of Understanding states that this definition of tax fraud also is applicable for purposes of applying other means of mutual assistance in matters involving tax fraud in order to obtain assistance, such as the deposition of witnesses.

Any information exchanged is to be 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 assessment, collection, administration, enforcement, prosecution or determination of appeals with respect to the taxes covered by the proposed treaty. The information exchanged may be used only for the purposes stated above.[13] The Technical Explanation states that the appropriate committees of the U.S. Congress and the U.S. General Accounting Office shall be afforded access to information for use in the performance of their role in overseeing the administration of U.S. tax laws. The Memorandum of Understanding clarifies that exchanged information may be disclosed in public court proceedings or judicial decisions.

As is true under the present treaty and the U.S. and OECD models, under the proposed treaty, a country is not required to carry out administrative measures at variance with the regulations and practice of either country or which would be contrary to its sovereignty, security or public policy, to supply information which is not obtainable under the laws of either country, or to supply information which would disclose any trade, business, industrial, or professional secret or trade process. The Memorandum of Understanding confirms that Swiss bank secrecy laws do not hinder the gathering of documentary evidence from banks or the forwarding of such evidence under the proposed treaty to the U.S. competent authority in cases involving tax fraud.

The proposed treaty further provides that the competent authorities may provide to an arbitration board (established pursuant to Article 25) such information as is necessary for the arbitration procedure. However, the limitations on disclosure contained in this article will apply to the members of the arbitration board.

The proposed treaty also provides for administrative cooperation between the two countries in collecting taxes to the extent necessary to ensure that certain treaty benefits do not inure to the benefit of persons not entitled to such benefits. Under the proposed treaty, each country may collect taxes imposed by the other country as though such taxes were its own in order to ensure that the exemption or reduced rate of tax granted by the other state under the

[13] Code section 6103 provides that otherwise confidential tax information may be utilized for a number of specifically enumerated non-tax purposes. Information obtained by the United States pursuant to this treaty could not be used for these non-tax purposes.

dividends, interest, royalties, and pensions and annuities articles will not be enjoyed by persons not entitled to such benefits.

Article 27. Members of Diplomatic Missions and Consular Posts

The proposed treaty contains the rule found in other U.S. tax treaties that its provisions are not to affect the fiscal privileges of diplomatic agents or consular officials under the general rules of international law or 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 U.S. residents who are neither U.S. citizens nor green-card holders. Thus, Swiss diplomats who are considered U.S. residents generally may be protected from U.S. tax.

The proposed treaty provides that, to the extent that income is not subject to tax in the receiving country because of the fiscal privileges granted to diplomatic agents or consular officers, the right to tax such income is reserved to the sending country. This provision does not affect the fiscal privileges provided under international law or special international agreements but rather modifies the terms otherwise provided in the proposed treaty in order to prevent such income from escaping tax in both countries.

The proposed treaty provides a special rule for determining the country of residence of individuals who are members of a diplomatic mission, consular post, or permanent mission of one country located in the other country or in a third country. Under this rule, for purposes of the proposed treaty, such an individual will be deemed to be a resident of the sending country if (1) under international law he or she is not liable to tax in the receiving country on income from sources outside that country and (2) he or she is liable in the sending country to the same obligations with respect to tax on his or her total income as are residents of that country. Under this rule, a U.S. diplomat stationed in a third country would be treated as a U.S. resident for purposes of determining whether he or she is eligible for reduced rate of, or exemption from, Swiss tax on Swiss-source income.

The proposed treaty does not apply to international organizations, organs and officials of such organizations, and persons who are members of a diplomatic mission, consular post or permanent mission of a third country present in one of the treaty countries, if such persons are not treated in either of the treaty countries as residents for purposes of the country's income taxes.

Article 28. Miscellaneous

This article contains various rules that apply throughout the proposed treaty.

The proposed treaty provides that it does not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance accorded by internal law or by any other agreement between the United States and Switzerland. Thus, the proposed treaty will not apply to increase the tax burden of a resident of either the United States or Switzerland. According to 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 Switzerland 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, 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 constitute a permanent establishment to offset the taxable income of the permanent establishment. [14]

The proposed treaty provides that the dispute resolution procedures under its mutual agreement article take precedence over the corresponding provisions of any other agreement to which the United States and Switzerland are parties in determining whether a measure is within the scope of the proposed treaty. Unless the competent authorities agree that a taxation measure is outside the scope of the proposed treaty, only the proposed treaty's nondiscrimination rules, and not the nondiscrimination rules of any other agreement in effect between the United States and Switzerland, generally apply to that law or other measure. The only exception to this general rule is such national treatment or most favored nation obligations as may apply to trade in goods under the General Agreement on Tariffs and Trade. For purposes of this provision, the term "measure" means a law, regulation, rule, procedure, decision, administrative action, or any other form of measure.

The proposed treaty contains a rule providing that any income, gain, or expense attributable to a permanent establishment during its existence is taken into account in the country where such permanent establishment was located even if the amounts are deferred until after the permanent establishment has ceased to exist. This rule applies for purposes of paragraphs 1 and 2 of Article 7 (Business Profits), paragraph 5 of Article 10 (Dividends), paragraph 3 of Article 11 (Interest), paragraph 3 of Article 12 (Royalties), paragraph 3 of Article 13 (Gains), paragraph 2 of Article 14 (Independent Personal Services), and paragraph 2 of Article 21 (Other Income). Under this rule, which is described above in the discussion of these articles, items that are attributable to a permanent establishment are taxed under the rules applicable to business profits and not the rules applicable to specific types of income such as interest or dividends, even if such items are deferred until after the termination of the permanent establishment.

[14] See Rev. Rul. 84–17, 1984–1 C.B. 308.

The proposed treaty includes a special rule regarding cross-border pension contributions. This rule applies where an individual is resident in and performs personal services in one of the countries but is not a national of such country. Contributions paid by or on behalf of such individuals to a pension or other retirement arrangement that is established, maintained, and recognized for tax purposes in the other country will be treated for purposes of taxation in the host country in the same way as a contribution to a pension or other retirement arrangement established, maintained, and recognized for tax purposes in the host country. However, this rule applies only if two conditions are met. First, the individual must not have been a resident of the host country, and must have been contributing to that pension or other retirement arrangement, immediately before he or she began exercising employment in that country. Second, the competent authority of the host country must agree that the pension or other retirement arrangement in the other country generally corresponds to an arrangement that is recognized for tax purposes in the host country. Under the proposed treaty, the benefits of this rule are applicable only for a period not exceeding five taxable years beginning with the first year in which the individual rendered personal services in the host country. A pension or retirement arrangement is recognized for tax purposes in a country if the contributions to and the earnings of such arrangement would qualify for tax relief in such country. The Technical Explanation states that this rule applies to an individual retirement account. The Technical Explanation further states that the benefits to be provided by the host country under this rule are limited to the benefits that such country would provide to arrangements recognized under its law.

The proposed treaty includes a provision with respect to the effect of changes in the law of either country. The appropriate authority of either country may request consultations with the appropriate authority of the other country to determine whether an amendment to the proposed treaty is appropriate to address a change in the law or policy of either country. If, as a result of these consultations, a determination is made that the effect or application of the proposed treaty have been changed unilaterally by reason of domestic legislation enacted by a country such that the balance of the benefits provided by the proposed treaty have been altered significantly, such authorities will consult with a view toward amending the treaty to restore an appropriate balance. The Technical Explanation notes that any such amendment would be subject to Senate advice and consent to ratification.

Article 29. Entry Into Force

The proposed treaty will enter into force on the day of the exchange of instruments of ratification. The provisions of the proposed treaty generally take effect for taxable years and periods beginning on or after the first day of January in the year following the date of entry into force. In the case of taxes payable at source, the proposed treaty generally takes effect for payments made on or after the first day of the second month following the date of entry into force.

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 ceases to have effect once the provisions of the proposed treaty take effect under the proposed treaty.

Article 30. Termination

The proposed treaty will continue in force until terminated by a treaty country. Either country may terminate it by giving at least six months' prior notice through diplomatic channels. Unlike many U.S. tax treaties, but like the U.S. model, the proposed treaty does not contain a rule which provides that either country may terminate the treaty only after it has been in force for five years. A termination generally will be effective for taxable years and periods beginning on or after the first day of January following the expiration of the six-month period. With respect to taxes payable at source, a termination will be effective for payments made after the first day of January following the expiration of the six-month period.

IX. Text of the Resolution of Ratification

Resolved, (two-thirds of the Senators present concurring therein), That the Senate advise and consent to the ratification of the Convention between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income, signed at Washington, October 2, 1996, together with a Protocol to the Convention (Treaty Doc. 105–8), subject to the declarations of subsection (a), and the proviso of subsection (b).

(a) DECLARATIONS.—The Senate's advice and consent is subject to the following two declarations, which shall be binding on the President:

(1) REAL ESTATE INVESTMENT TRUSTS.—The United States shall use its best efforts to negotiate with the Swiss Confederation a protocol amending the Convention to provide the application of subparagraph (b) of paragraph 2 of Article 10 of the Convention to dividends paid by a Real Estate Investment Trust in cases where (i) the beneficial owner of the dividends beneficially holds an interest of 5 percent or less in each class of the stock of the Real Estate Investment Trust and the dividends are paid with respect to a class of stock of the Real Estate Investment Trust that is publicly traded or (ii) the beneficial owner of the dividends beneficially holds an interest of 10 percent or less in the Real Estate Investment Trust and the Real Estate Investment Trust is diversified.

(2) TREATY INTERPRETATION.—The Senate affirms the applicability to all treaties of the constitutionally based principles of treaty interpretation set forth in Condition (1) of the resolution of ratification of the INF Treaty, approved by the Senate on May 27, 1988, and Condition (8) of the resolution of ratification of the Document Agreed Among the States Parties

to the Treaty on Conventional Armed Forces in Europe, approved by the Senate on May 14, 1997.

(b) PROVISO.—The resolution of ratification is subject to the following proviso, which shall be binding on the President:

(1) SUPREMACY OF THE CONSTITUTION.—Nothing in the Treaty requires or authorizes legislation or other action by the United States of America that is prohibited by the Constitution of the United States as interpreted by the United States.

APPENDIX

DEPARTMENT OF STATE,
WASHINGTON, DC,
APRIL 8, 1997.

His Excellency, CARLO JAGMETTI,
Ambassador of Switzerland.

EXCELLENCY:

I have the honor to refer to the Convention Between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income, with Protocol, signed at Washington, October 2, 1996, and to diplomatic notes, with an enclosed Memorandum of Understanding clarifying application of the Convention in specified cases, which were exchanged on the same date.

The Memorandum of Understanding is a statement of intent setting forth a common understanding and interpretation of certain provisions of the Convention reached by the delegations of the United States and the Swiss Confederation acting on behalf of their respective governments. These understandings and interpretations are intended to give guidance both to the taxpayers and the tax authorities of our two countries in interpreting these provisions. Since the notes were exchanged, several additional matters regarding the interpretation of the Convention have been identified. In order to address these matters, several additions have been made to the Memorandum of Understanding. The Memorandum of Understanding that reflects these additions is enclosed herewith.

If the understandings and interpretations in the Memorandum of Understanding are acceptable, this note and your note reflecting such acceptance will memorialize the understandings and interpretations that the parties have reached. I further propose that the Memorandum of Understanding enclosed with this Note will replace the original Memorandum of Understanding.

Accept, Excellency, the renewed assurances of my highest consideration.

For the Secretary of State:

BARBARA J. GRIFFITH

Enclosure: As stated

THE CHARGÉ D'AFFAIRES A.I. OF SWITZERLAND,
Washington, D.C., May 14, 1997.

DEAR MADAM SECRETARY:

I have the honor to confirm the receipt of your Note dated April 8, 1997 which reads as follows:

> "EXCELLENCY:
>
> I have the honor to refer to the Convention Between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income, with Protocol, signed at Washington, October 2, 1996, and to diplomatic notes, with an enclosed Memorandum of Understanding clarifying application of the Convention in specified cases, which were exchanged on the same date.
>
> The Memorandum of Understanding is a statement of intent setting forth a common understanding and interpretation of certain provisions of the Convention reached by the delegations of the United States and the Swiss Confederation acting on behalf of their respective governments. These understandings and interpretations are intended to give guidance both to the taxpayers and the tax authorities of our two countries in interpreting these provisions. Since the notes were exchanged, several additional matters regarding the interpretation of the Convention have been identified. In order

to address these matters, several additions have been made to the Memorandum of Understanding. The Memorandum of Understanding that reflects these additions is enclosed herewith.

If the understandings and interpretations in the Memorandum of Understanding are acceptable, this note and your note reflecting such acceptance will memorialize the understandings and interpretations that the parties have reached. I further propose that the Memorandum of Understanding enclosed with this Note will replace the original Memorandum of Understanding.

Accept, Excellency, the renewed assurances of my highest consideration.

For the Secretary of State:

Attachment

The Honorable MADELEINE ALBRIGHT,
Secretary of State
United States Department of State
Washington, D.C.

I have the honor to inform you that the understandings and interpretations in the Memorandum of Understanding are acceptable.

Accept, Madam Secretary, renewed assurances of my highest consideration.

The Chargé d'Affaires a.i. of Switzerland,
PIERRE COMBERNOUS.

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