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TAX CONVENTION WITH ITALY

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

REPORT

[To accompany Treaty Doc. 106–11]

The Committee on Foreign Relations, to which was referred the Convention between the Government of the United States of America and the Government of the Italian Republic for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fraud or Fiscal Evasion, signed at Washington on August 25, 1999, together with a Protocol, having considered the same, reports favorably thereon, with one reservation, one understanding, one declaration, 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.

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I. PURPOSE

The principal purposes of the proposed income tax treaty between the United States and Italy 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 and facilitate trade and investment between the two countries. It also

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is intended to 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 August 25, 1999. The United States and Italy also exchanged notes on the same day with an attached Memorandum of Understanding to provide clarification with respect to the application of the proposed treaty. The proposed treaty would replace the existing income tax treaty between the United States and Italy that was signed in 1984.

The proposed treaty, together with the proposed protocol and the exchange of notes, were transmitted to the Senate for advice and consent to its ratification on September 21, 1999 (see Treaty Doc. 106–11). The Committee on Foreign Relations held a public hearing on the proposed treaty on October 27, 1999.

III. SUMMARY

The proposed treaty is similar to other recent U.S. income tax treaties, the 1996 U.S. model income tax treaty ("U.S. model"), and the model income tax treaty of the Organization for Economic Cooperation and Development ("OECD model"). However, the proposed treaty contains certain substantive deviations from those treaties and models.

As in other U.S. tax treaties, these objectives principally are achieved through each country's agreement to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other country. For example, the proposed treaty contains provisions under which each country generally agrees not to tax business income derived from sources within that country by residents of the other country unless the business activities in the taxing country are substantial enough to constitute a permanent establishment or fixed base (Articles 7 and 14). Similarly, the proposed treaty contains "commercial visitor" exemptions under which residents of one country performing personal services in the other country will not be required to pay tax in the other country unless their contact with the other country exceeds specified minimums (Articles 14, 15, and 17). The proposed treaty provides that dividends, interest, royalties, and certain capital gains derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles 10, 11, 12, and 13); however, the rate of tax that the source country may impose on a resident of the other country on dividends, interest, and royalties generally will be limited by the proposed treaty (Articles 10, 11, and 12).

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 proposed treaty generally provides for relief from the potential double taxation through the allowance by the country of residence of a tax credit for certain foreign taxes paid to the other country (Article 23).

The proposed treaty contains the standard provision (the "saving clause") included in U.S. tax treaties pursuant to which each country retains the right to tax its residents and citizens as if the treaty had not come into effect (Article 1). In addition, the proposed protocol contains the standard provision providing that the treaty 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.

The proposed treaty contains certain "main purpose" tests which operate to deny the benefits of the dividends article (Article 10), the interest article (Article 11), the royalties article (Article 12) and the other income article (Article 22) if the main purpose or one of the main purposes of a person is to take advantage of the benefits of the respective article through a creation or assignment of shares, debt claims, or rights that would give rise to income to which the respective article would apply.

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

IV. Entry Into Force and Termination

A. ENTRY INTO FORCE

The proposed treaty will enter into force upon the exchange of instruments of ratification. The present treaty ceases to have effect once the provisions of the proposed treaty take effect.

In the case of taxes withheld at source, the proposed treaty takes effect for amounts paid or credited on or after the first day of the second month following the date on which the proposed treaty enters into force. In the case of other taxes, the proposed treaty takes effect for taxable periods beginning on or after the first day of January next following the date on which the proposed treaty enters 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 a twelve-month period from the date on which the provisions of the proposed treaty would otherwise take 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 after five years from the date of entry into force, provided that at least six months prior notice of termination is given through diplomatic channels. With respect to taxes withheld at source, a termination will be effective for amounts paid or credited on or after the first of January following the expiration of the six-month period. With respect to other taxes, a termination will be effective 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 Italy (Treaty Doc. 106–11), as well as on other proposed treaties and protocols, on October 27, 1999. The hearing was chaired by Senator Hagel. The Committee considered these proposed treaties and protocols on November 3, 1999, and ordered the proposed treaty with Italy favorably reported by a voice vote, with the recommendation that the Senate give its advice and consent to ratification of the proposed treaty, subject to a reservation, an understanding, a declaration, and a proviso.

VI. COMMITTEE COMMENTS

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

A. MAIN PURPOSE TESTS

In general

The proposed treaty includes a series of "main purpose" tests that can operate to deny the benefits of the dividends article (Article 10), the interest article (Article 11), the royalties article (Article 12), and the other income article (Article 22). This series of main purpose tests is not found in any other U.S. treaty, and is not included in the U.S. model or the OECD model.[1]

Description of provisions

Under the proposed treaty, the provisions of the dividends article (Article 10) will not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the shares or rights in respect of which the dividend is paid to take advantage of the dividends article by means of that creation or assignment. Similarly, the interest article (Article 11) provides that its provisions will not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the debt claim in respect of which the interest is paid to take advantage of the interest article by means of that creation or assignment. Substantially similar main purpose tests apply in the case of the royalties article (Article 12) and the other income article (Article 22).

The Technical Explanation indicates that the main purpose tests are to be "self-executing." The Technical Explanation further states that the tax authorities of one of the treaty countries may, on review, deny the benefits of the respective article if the conditions of the main purpose tests are satisfied. In addition, the proposed protocol provides that under the mutual agreement procedures article (Article 25) the competent authorities of the treaty countries may agree that the conditions for application of the main purpose tests

[1] Although not included in the OECD model, paragraph 17 of the commentary to the dividends article of the OECD model suggests that the treaty partners may find it appropriate to adopt a rule to deny treaty benefits if the acquisition of stock was "primarily for the purpose of taking advantage of this provision."

are met. The Technical Explanation states that the competent authority agreement does not have to relate to a particular case. Rather, if the competent authorities agree that a type of transaction entered into by several taxpayers is entered into with a main purpose of taking advantage of the treaty, treaty benefits can be denied to all taxpayers who had entered into such a transaction. The Technical Explanation states that it is anticipated that the public would be notified of such generic agreements through the issuance of press releases.

Committee concerns with the "main purpose" tests

The Committee has several concerns with the new main purpose tests. The inclusion of such tests in the specific articles of the proposed treaty represents a fundamental shift in U.S. treaty policy. As a general matter, such changes in policy should be made only after careful consideration of whether circumstances warrant such a change, and whether the proposed change is appropriate. The Treasury Department should engage in meaningful consultations with the Congress when proposing to make such a policy shift. The Committee is concerned that such consultations did not occur in this instance, and that the Committee has not been afforded an opportunity to weigh the relevant policy considerations (including whether a need for such a provision exists) and to evaluate alternative approaches with respect to the proposed new tests.

The Treasury Department has acknowledged that the United States presently has the right to apply its domestic law (including anti-abuse principles such as the business purpose doctrine) in the treaty context; this is a broad authority that would allow treaty benefits to be denied in tax avoidance transactions. The Treasury Department has stated, however, that the proposed main purpose tests are intended to go beyond present U.S. domestic law. Although the Committee shares the Treasury Department's concern with abusive transactions, the Treasury Department has not convinced the Committee that a higher standard is necessary in U.S. treaties than that which applies under domestic law. In addition, the Committee is concerned that the Treasury Department has not adequately explained the potential implications of going beyond present U.S. law in the treaty context.

The new main purpose tests in the proposed treaty are subjective, vague and add uncertainty to the treaty. It is unclear how the provisions are to be applied. In addition, the provisions lack conformity with other U.S. tax treaties. This uncertainty could create difficulties for legitimate business transactions, and can hinder a taxpayer's ability to rely on the treaty.

In the past, the United States has determined that subjective tests are not appropriate in the treaty context. For example, older U.S. treaties containing limitation on benefits provisions (which address an abuse of a treaty whereby residents of third countries try to take advantage of the treaty provisions through what is known as treaty shopping) applied broad subjective tests looking to whether the acquisition, maintenance, or operation of an entity did not have "as a principal purpose obtaining benefits under" the treaty. These subjective tests have been replaced in recent treaties (including the proposed treaty) with limitation on benefits provisions that apply clear, bright-line objective tests (such as ownership and base erosion tests, public company tests, as well as active business tests). The reasons for moving away from subjective standards are illustrated by a statement in the Technical Explanation to the limitation on benefits provision of the proposed treaty that acknowledges in connection with a principal purpose test that a "fundamental problem presented by this approach is that it is based on the taxpayer's motives in establishing an entity in a particular country, which a tax administrator is normally ill-equipped to identify." Although this criticism is specific to a principal purpose test with respect to an anti-treaty shopping provision, the same concern applies with respect to subjective tests in general.

The main purpose standard in the relevant provisions of the proposed treaty is that "the main purpose or one of the main purposes" is to "take advantage of" the particular article in which the main purpose tests appear. This is a subjective standard, dependent upon the intent of the taxpayer, that is difficult to evaluate. Such a standard is inconsistent with present U.S. treaty policy. In addition, the Committee is concerned that a broad standard based on whether one of the main purposes of a taxpayer is to take advantage of a particular treaty provision does not adequately distinguish between legitimate business transactions and tax avoidance transactions. While it is true that under U.S. domestic law, "a principal purpose" test is used as an anti-abuse rule in a variety of contexts, its use generally has been limited to circumscribed situations. The Committee is concerned that the circumstances for inclusion of a main purpose test in the proposed treaty are not well-defined and that the standard potentially has much broader implications in the treaty context then in its analogs under U.S. domestic law. The Committee believes that consideration should be given to alternative formulations of anti-abuse standards, including objective standards such as those contained in the limitation on benefits provisions of modern U.S. income tax treaties.

It is also unclear how the proposed main purpose tests would be administered. The Technical Explanation indicates that the tests are intended to be self-executing. In the absence of a taxpayer applying the tests to itself, the tax authorities of one of the countries may, on review, deny the treaty benefits. The Committee is concerned that the Treasury Department has not provided adequate assurances that the tests will not be used by treaty partners to deny treaty benefits for legitimate business activity.

A fairness question also may be raised insofar as the proposed treaty provides the competent authorities with the ability to declare an entire class of transactions as abusive and, accordingly, deny treaty benefits to that class without the necessity of evaluating the facts of each specific transaction. It is unclear what degree of deference would be accorded to such a competent authority agreement by responsible tax administrative authorities or by the courts. Moreover, because the main purpose tests do not appear in other U.S. treaties or with respect to other articles of this proposed treaty, an issue arises as to whether its inclusion in specific provisions of this proposed treaty creates a negative inference as to the United States' ability to raise its internal anti-abuse rules in connection with other treaties (or other provisions of this proposed treaty) in which such main purpose tests do not appear. The Technical Explanation states that no such inference with respect to other treaties is intended. The Committee believes that further consideration and analysis of these issues are necessary.

Committee conclusions

The Committee shares the Treasury Department's concerns with respect to abusive transactions that inappropriately take advantage of treaty benefits. The Committee does not believe, however, that the main purpose tests in the proposed treaty have been fully and adequately developed. The Committee believes that there are many issues, including the need for such tests and, if needed, what the appropriate tests should be as a matter of U.S. treaty policy, that must be addressed before it would be appropriate to include such provisions in any U.S. income tax treaty. Accordingly, the Committee has included in its recommended resolution of ratification a reservation requiring that the main purpose tests be stricken from the proposed treaty and proposed protocol.

Notwithstanding the Committee's concerns with the main purpose tests in the proposed treaty and its recommendation of a reservation in this regard, on balance the Committee believes that the proposed treaty with Italy is in the interest of the United States and strongly urges the Treasury Department to pursue an exchange of instruments of ratification with the aforementioned reservation with the same zeal with which it negotiated the proposed treaty in the first instance.

In addition, the Committee is committed to working with the Treasury Department to develop appropriate ways to address tax avoidance in the treaty context. The Committee requests that the Treasury Department provide it with a comprehensive analysis of (1) the need for a main purpose or similar test including specific examples of abusive transactions that cannot be adequately addressed under present U.S. law; (2) alternatives to such a test including alternatives that rely on objective standards; (3) the interaction of such a test with present domestic law and the corresponding rules under the relevant foreign law; (4) any potential inferences that may be created with respect to other U.S. treaties and other provisions of the specific treaty that do not contain such a test; (5) the expected standards of judicial review with respect to the application of such a test and the degree of deference that may be accorded to competent authority agreements with respect to such a test; (6) the experience of foreign countries that presently include such a test or similar tests in their income tax treaties; and (7) any other relevant considerations.

Until these issues have been fully considered by both the Treasury Department and the Committee, the Committee strongly recommends that the Treasury Department not modify its model treaty to include these or similar main purpose tests and not include such main purpose tests or similar tests in future treaties.

B. CREDITABILITY OF ITALIAN IRAP TAX

United States law, subject to certain limitations, allows a credit for income, war profits or excess profits taxes paid to a foreign country. In general, to be a creditable tax under U.S. law, the tax must be likely to reach net gain in the normal circumstances in which it applies.

In addition to the individual income tax and the corporation income tax, the proposed treaty provides for creditability of a portion of the Italian regional tax on productive activities (l'imposta regionale sulle attivita produttive or "IRAP"). Effective January 1, 1998, the IRAP replaced Italy's local income tax (l'imposta locale sul redditi or "ILOR"), which is treated as a creditable tax under the present U.S.-Italy treaty. Unlike the ILOR, the IRAP is calculated without a deduction for labor costs and, for certain taxpayers, without a deduction for interest costs. As a result, the tax base is not similar enough to a U.S. income tax base such that it is not likely to reach net gain. The IRAP therefore is unlikely to be a creditable tax under U.S. law, absent a special treaty provision.

In general, the proposed treaty provides a formula under which the amount of the IRAP that is considered to be a creditable income tax under the proposed treaty is determined by multiplying the amount of the IRAP actually paid or accrued by a fraction. The numerator of the fraction represents an amount approximating the taxpayer's business profits that would be subject to the IRAP if deductions for interest and labor costs were allowed. The denominator of the fraction equals the actual tax base upon which Italy imposes the IRAP. Thus, if the IRAP tax base is twice that which it would have been if it permitted deductions for interest and labor (and therefore more closely approximated net income), then only half of the amount paid would be treated as a creditable income tax under the proposed treaty. That amount then would be subject to the other limitations on foreign tax credits under U.S. law.

The Committee believes that treaties should not be used to provide a credit for taxes that may not otherwise be creditable under U.S. law. It may be more appropriate for such results to be accomplished in the normal course of internal U.S. tax legislation. The tax credits allowed under the proposed treaty for IRAP taxes likely are larger than the credits otherwise allowed under the Code and Treasury regulations and, therefore, potentially would reduce the U.S. taxes collected from U.S. companies operating in Italy.

In addition, the Committee is concerned with the proposed treaty's mechanism for determining the amount of the IRAP that is treated as a creditable income tax for U.S. foreign tax credit purposes. In essence, in order to claim a credit for a portion of the IRAP, the proposed treaty takes the unusual step of requiring a calculation of a hypothetical portion of tax actually imposed under the IRAP that would more likely resemble a creditable income tax under U.S. tax principles, and then guarantees that such portion is eligible for the U.S. foreign tax credit. Such a hypothetical calculation is not consistent with U.S. treaty policy. The Committee strongly recommends that such hypothetical calculations not be used in future treaties to address foreign tax credit issues with respect to otherwise noncreditable taxes, particularly with respect to taxes not designed to reach net gain such as value added taxes.

The Committee recognizes that special circumstances exist with respect to the proposed treaty. The IRAP has recently replaced the ILOR, which is a creditable income tax under the present U.S.-

Italy treaty. In these circumstances it could be viewed as unfair to disadvantage U.S. enterprises doing business in Italy because of a change in Italian law. The formula provided in the proposed treaty is designed to limit the amount of the creditable IRAP tax under the proposed treaty to an amount that could be considered to be creditable under U.S. internal law if the IRAP were designed (like the ILOR which it replaced) to reach net gain. The Committee believes that given these circumstances, it is justifiable to provide a credit for a portion of the IRAP in the manner provided under the proposed treaty. However, the Committee does not believe that this provision should be construed in any way as a precedent for future treaties to provide creditability for otherwise non-creditable taxes under U.S. domestic law such as value added taxes. The Committee expects the Treasury Department to closely monitor the application of this formulary approach to the IRAP and to promptly notify the Committee as to whether such approach is achieving its intended results.

C. INSURANCE EXCISE TAX

The proposed protocol, like the protocol to the present treaty, waives the U.S. excise tax on insurance premiums paid to foreign insurers under certain circumstances. With the waiver of the excise tax on insurance premiums, for example, an Italian 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 Italian 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 concerns in the past. 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 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.[2] 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 the

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

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 Italy. The Committee understands that, unlike Bermuda and Barbados, Italy 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 Italian income tax imposed on Italian 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 Treasury Department's October 29, 1999, memorandum [3] responding to this inquiry is reproduced below:

> Treasury recognizes the policy concerns about the competitiveness of U.S. insurance companies that serve as the basis for the imposition of the excise tax on foreign insurers insuring U.S. risks. Consistent with these policy concerns, the Treasury Department will only agree to cover this excise tax in an income tax convention, and thereby grant an exemption from the tax, if Treasury is satisfied that an insurer that is a resident of the treaty partner and is insuring U.S. risks would face a level of taxation that is substantial relative to the level of taxation faced by U.S. insurers.
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> During the course of negotiations, Treasury conducted a thorough review of Italian law and information on Italian insurance company operations. This review demonstrated that insurance companies that are resident in Italy are subject to a substantial level of tax in Italy. Accordingly, it was determined that U.S. insurance companies would not be placed at a competitive disadvantage by the retention of coverage of the excise tax in the proposed treaty.

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 Italian insurers and U.S. insurers, the Committee believes that the waiver of the excise tax for Italian insurers is consistent with the criteria the Committee has articulated for such waivers. The Committee expects the Treasury Department to closely monitor and to promptly notify the Committee of any changes in law or business practices that would have an impact on the tax burden of Italian insurers relative to that of U.S. insurers.

D. SHIPPING AND AIRCRAFT INCOME

Income from the rental of ships and aircraft

The proposed treaty, like the present 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

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[3] Memorandum from the Treasury Department for Senator Hagel, October 29, 1999 ("October 29, 1999 Treasury Department memorandum").

international traffic are taxable only in the enterprise's country of residence. For this purpose, the operation of ships or aircraft in international traffic includes profits derived from the rental of ships or aircraft on a full (time or voyage) basis. Like the present treaty, in the case of profits derived from the rental of ships and aircraft on a bareboat (without a crew) basis, the rule limiting the right to tax to the country of residence applies to such rental profits only if the bareboat rental profits are incidental to other profits of the lessor from the operation of ships and aircraft in international traffic. Such bareboat 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 royalties at a 5-percent rate (or 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 or aircraft. Under the proposed treaty, unlike under the U.S. model, an enterprise that engages only in the rental of ships and aircraft on a bareboat basis, but does not engage in the operation of ships and aircraft, would not be eligible for the rule limiting the right to tax income from operations in international traffic to the enterprise's country of residence. It should be noted that under the proposed treaty, profits from the use, maintenance, or rental of containers used in international traffic are taxable only in the country of residence.

Gains from the sale of ships and aircraft

The proposed treaty, like the present treaty, includes a provision found in the U.S. model and many U.S. income tax treaties under which gains derived by an enterprise from one of the treaty countries from the alienation of ships or aircraft operated in international traffic (or movable property pertaining to the operation or use of ships, aircraft or containers) are taxable only in the country of residence, regardless of the existence of a permanent establishment in the other country. For this purpose, the proposed protocol provides that this rule also applies to gains from the sale of containers used for the transport in international traffic of goods and merchandise, and gains from the sale of ships or aircraft rented on a full basis. Like the present treaty, in the case of gains from the sale of ships or aircraft rented on a bareboat basis, the rule limiting the right to tax to the country of residence applies to such gains only if the rental profits from such bareboat rentals are incidental to other profits of the lessor from the operation of ships or aircraft in international traffic. Such gains that are not incidental to other income from the 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 gains from the sale of ships and aircraft operated in international traffic are taxable only in the country of residence, without requiring that the rental profits from the use of such ships be incidental to income of the recipient from the operation of ships or aircraft. Under the proposed treaty, unlike under the U.S. model, an enterprise that engages only in the rental of ships and aircraft on a bareboat basis, but does not engage in the operation of ships and aircraft, would not be eligible for the rule limiting the right to tax income from operations in international traffic to the enterprise's country of residence. It should be noted that under the proposed treaty gains from the sale of containers used in international traffic are taxable only in the country of residence.

Committee conclusions

As part of its consideration of the proposed treaty, the Committee asked the Treasury Department whether the proposed treaty's rules with respect to income derived from the rental of ships and aircraft, and gains from the sale of ships and aircraft, are appropriate. The relevant portion of the October 29, 1999, Treasury Department memorandum responding to this inquiry is reproduced below:

> Although it is the preferred U.S. policy to extend the source-country exemption to include non-incidental income from the bareboat rental of ships and aircraft (and gains from the disposition of such ships and aircraft), Italy was unwilling to change the existing treaty on this point because of its strong treaty policy against such exemptions. Indeed, the inclusion of a source-country exemption for rental income (and gains) from containers used in international traffic represents a significant departure for Italy from its normal treaty policy.

The provisions in the proposed treaty represent a departure from the U.S. model. The Committee believes that in negotiating future treaties, the Treasury Department should continue to seek provisions that conform more closely to the U.S. model.

E. TREATY SHOPPING

The proposed treaty, like a number of 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 only residents of Italy and the United States, 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. 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 of the proposed treaty is similar to anti-treaty-shopping provisions in the Code (as interpreted by Treasury regulations) and in several recent treaties. Some aspects of the provision, however, differ from the anti-treaty-shopping provision in the U.S. model.

One provision of the anti-treaty shopping article differs from the comparable rule of some earlier U.S. treaties, but the effect of the change is not clear. The general test applied by those treaties to allow benefits to an entity that does not meet the bright-line ownership and base erosion tests is a broadly subjective one, looking to whether the acquisition, maintenance, or operation of an entity did not have "as a principal purpose obtaining benefits under" the treaty. By contrast, the proposed treaty contains a more precise test that allows denial of benefits only with respect to income not derived in connection with (or incidental to) the active conduct of a substantial trade or business. (However, this active trade or business test does not apply with respect to a business of making or managing investments carried on by a person other than a bank, insurance company, or registered securities dealer; so benefits may be denied with respect to such a business regardless of how actively it is conducted.) In addition, the proposed treaty (like all recent treaties) gives the competent authority of the country in which the income arises the authority to determine that the benefits of the treaty will be granted to a person even if the specified tests are not satisfied.

The Committee believes that limitation on benefits provisions are important to protect against "treaty shopping" by limiting benefits of a treaty to bona fide residents of the treaty partner. The Committee further believes that the United States should maintain its policy of limiting treaty shopping opportunities whenever possible. The Committee continues to believe further that, in exercising any latitude the Treasury Department has to adjust the operation of the proposed treaty, the rules as applied should adequately deter treaty shopping abuses. The proposed anti-treaty-shopping provision may be effective in preventing third-country investors from obtaining treaty benefits by establishing investing entities in Italy because third-country investors may be unwilling to share ownership of such investing entities on a 50-50 basis with U.S. or Italian residents or other qualified owners in order to meet the ownership test of the anti-treaty-shopping provision. In addition, the base erosion test provides protection from certain potential abuses of an Italian conduit. Finally, Italy imposes significant taxes of its own; these taxes may deter third-country investors from seeking to use Italian entities to make U.S. investments. On the other hand, implementation of the tests for treaty shopping set forth in the treaty may raise factual, administrative, or other issues that cannot currently be foreseen. The Committee emphasizes that the proposed anti-treaty-shopping provision must be implemented so as to serve as an adequate tool for preventing possible treaty shopping abuses in the future.

F. ARBITRATION UNDER THE MUTUAL AGREEMENT PROCEDURES

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 disputes regarding individual cases of double taxation not in accordance with the proposed treaty. Several conditions would have to be satisfied before this arbitration procedure could be utilized. First, the two countries would have to exchange diplomatic notes implementing this arbitration procedure; until that occurs, the arbitration procedure is not in effect. Second, the affected taxpayer must present his or her case to the competent authority. Third, the competent authority must first attempt to resolve the issue by itself, and if it cannot, then it must attempt to do so by mutual agreement with the competent authority of the other country. The Memorandum of Understanding explicitly states that the two countries will exchange the requisite diplomatic notes when the experience of the two countries with respect to a similar provision in the treaty between the U.S. and Germany has proven to be satisfactory.

The relevant portion of the Treasury Department's October 29, 1999, memorandum discussing this issue 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. For the foregoing reasons, and because Italy was strongly interested in the provision, it was included in the proposed treaty.

The Committee continues to believe that the tax system potentially has 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.

The Committee's willingness to accommodate this arbitration procedure is strongly influenced by the fact that the proposed treaty would allow for a binding arbitration procedure only if agreed by both competent authorities and the taxpayer or taxpayers involved. The Committee believes that it would be inappropriate for any future treaty to include an arbitration procedure that did not contain this provision, which allows for a binding arbitration procedure only if agreed by both competent authorities and the taxpayer or taxpayers involved.

G. EXCHANGE OF INFORMATION

One of the principal purposes of the proposed treaty between the United States and Italy is to prevent avoidance or evasion of taxes of the two countries. The exchange of information article of the proposed treaty (Article 26) is one of the primary vehicles used to achieve that purpose.

The exchange of information article contained in the proposed treaty generally conforms to the corresponding article of the OECD model and the U.S. model.[4] As is true under these model treaties, under the proposed treaty a country is not required to carry out administrative measures at variance with the laws and administrative practice of either country, to supply information that is not obtainable under the laws or in the normal course of the administration of either country, or to supply information that discloses any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which is contrary to public policy.

The exchange of information article contained in the proposed treaty varies significantly from the U.S. model in one respect: the authority to obtain information from third parties (commonly referred to as the "bank secrecy" provision). This provision of the U.S. model provides that, notwithstanding the limitations described in the preceding paragraph, a country has the authority to obtain and provide information held by financial institutions, nominees, or persons acting in a fiduciary capacity. This information must be provided to the requesting country notwithstanding any laws or practices of the requested country that would otherwise preclude acquiring or disclosing such information.

One issue the Committee has considered is the significance of the omission of this provision with respect to this proposed treaty. According to the Technical Explanation to Article 26, the United States has received assurances from the Italian Ministry of Finance concerning Italy's ability to exchange third-party information obtained from banks and other financial institutions. The Treasury Department has received a letter dated October 11, 1999, from the Ministry of Finance of the Republic of Italy containing these assurances. Because of the Committee's view as to the vital nature of these exchanges of third-party information, the Committee has conditioned ratification of the proposed treaty on the following understanding, which shall be included in the instrument of ratification, and shall be binding on the President:

> EXCHANGE OF INFORMATION.—The United States understands that, pursuant to Article 26 of the Convention, both the competent authority of the United States and the competent authority of the Republic of Italy have the authority to obtain and provide information held by financial institu-

[4] This takes into account Article 1, paragraph 20 of the proposed protocol (including authorities involved in the oversight of tax administration within the ambit of persons to whom information may be disclosed) and the Technical Explanation of Article 26 of the treaty (stating that "necessary" is to be interpreted equivalently to "relevant" with respect to the scope of the exchange of information provision).

tions, nominees or persons acting in an agency or fiduciary capacity, or respecting interests in a person.

Another issue the Committee has considered is the implications of the omission of this provision from this treaty with respect to future treaty negotiations. While some treaty partners do not object to this bank secrecy provision, other treaty partners have resisted its inclusion in tax treaties. The broader issue of transparency of transactions involving third parties is a significant issue internationally. The United States has attempted to advance greater transparency in its treaty negotiations. It is possible that the omission of the bank secrecy provision from this treaty may be interpreted by other treaty partners as a weakening of the U.S. commitment to greater transparency and may make other treaty negotiations with respect to this issue more difficult. The Committee intends that the omission of this provision from this treaty does not indicate in any way a lessening of the commitment of the United States to pursue broader exchanges of information in future treaty negotiations.

The Committee would have serious concerns with respect to a proposed treaty if the other country restricted access to this information and were unwilling to change its internal laws to accommodate full exchanges of information. 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 maintain the benefits of a tax treaty relationship with the United States.

The Committee understands that the Treasury Department has stated that other countries have expressed "diplomatic" concerns regarding the bank secrecy provision in the current U.S. model. While the Committee is sensitive to these concerns, the Committee is at the same time fully committed to full exchanges of information with other treaty partners. The Committee understands that the Treasury Department may be considering removing this bank secrecy provision from the U.S. model. The Committee believes that, while revisions to that provision might be appropriate, it is vital that future tax treaties (as well as the U.S. model) retain explicit language providing for full exchanges of information, including exchanges of information held by third parties. The Committee expects that the Treasury Department will consult fully with the Committee prior to any modification of the U.S. model relating to this issue.

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 1999–2008 period.

VIII. Explanation of Proposed Treaty

A detailed, article-by-article explanation of the proposed income tax treaty between the United States and Italy, as supplemented by the proposed protocol, is set forth below. The United States and Italy also agreed upon a Memorandum of Understanding to provide clarification with respect to the application of the proposed treaty. 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 and certain aspects of the proposed protocol. A separate description of the proposed protocol is contained in Part IX.

Article 1. Personal Scope

Overview

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

The proposed treaty generally applies to residents of the United States and to residents of Italy, with specific modifications to such scope provided in other articles (e.g., Article 19 (Government Service), Article 24 (Non-Discrimination), and Article 26 (Exchange of Information)). This scope is consistent with the scope of other U.S. income tax treaties, the U.S. model, and the OECD model. For purposes of the proposed treaty, residence is determined under Article 4 (Resident).

The proposed protocol provides that the proposed treaty 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 Italy. Thus, the proposed treaty will not apply to increase the tax burden of a resident of either the United States or Italy. According to the Treasury Department's Technical Explanation (hereinafter referred to as the "Technical Explanation"), the fact that the proposed treaty only applies to a taxpayer's benefit does not mean that a taxpayer may select inconsistently among treaty and internal law provisions in order to minimize its overall tax burden. In this regard, the Technical Explanation sets forth the following example. Assume a resident of Italy has three separate businesses in the United States. One business is profitable and constitutes a U.S. permanent establishment. The other two businesses generate effectively connected income as determined under the Internal Revenue Code (the "Code"), but do not constitute permanent establishments as determined under the proposed treaty; one business is profitable and the other business generates a net loss. Under the Code, all three businesses would be subject to U.S. income tax, in which case the losses from the unprofitable business could offset the taxable income from the other businesses. On the other hand, only the income of the business which gives rise to a permanent establishment is taxable by the United States under the proposed treaty. The Technical Explanation makes clear that the taxpayer may not invoke the proposed treaty to exclude the profits of the profitable business that does not constitute a permanent establishment and invoke U.S. internal law to claim the loss of the unprofitable business that does not constitute a permanent establishment to offset the taxable income of the permanent establishment.[5]

The proposed protocol 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 Italy are parties in determining whether a measure is within the scope of the proposed treaty. The proposed protocol also provides that, unless the competent authorities agree that a taxation measure is outside the scope of the proposed treaty, only the proposed treaty's non-discrimination rules, and not the non-discrimination rules of any other agreement in effect between the United States and Italy, generally apply to that 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 similar provision or action.

Saving clause

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

The proposed protocol contains a provision under which the saving clause (and therefore the U.S. jurisdiction to tax) applies to a former U.S. citizen or long-term resident (whether or not treated as such under Article 4 (Resident)), whose loss of citizenship or resident status, respectively, had as one of its principal purposes the avoidance of tax; such application is limited to the ten-year period following the loss of citizenship or resident status. Section 877 of the Code provides special rules for the imposition of U.S. income tax on former U.S. citizens and long-term residents for a period of ten years following the loss of citizenship or resident status; these special tax rules apply to a former citizen or long-term resident only if his or her loss of U.S. citizenship or resident status had as one of its principal purposes the avoidance of U.S. income, estate, or gift taxes. For purposes of applying the special tax rules to former citizens and long-term residents, individuals who meet a specified income tax liability threshold or a specified net worth threshold generally are considered to have lost citizenship or resident status for a principal purpose of U.S. tax avoidance.

Exceptions to the saving clause are provided for the following benefits conferred by a treaty country: the allowance of correlative adjustments when the profits of an associated enterprise are adjusted by the other country (Article 9, paragraph 2); the exemption

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

from source-country tax for certain alimony, child support, and pension payments (Article 18, paragraphs 5 and 6); relief from double taxation through the provision of a foreign tax credit (Article 23); protection from discriminatory tax treatment with respect to transactions with residents of the other country (Article 24); and benefits under the mutual agreement procedures (Article 25). These exceptions to the saving clause permit residents or citizens of the United States or Italy to obtain such benefits of the proposed treaty with respect to their country of residence or citizenship. In addition, the proposed protocol provides that the saving clause does not override the exemption from source country tax of social security benefits (Article 18) for individuals who are citizens of the residence country even if they are citizens of both countries. The proposed protocol also provides that the saving clause does not override the special rule of Article 4 of the proposed protocol relating to a credit against Italian taxes for U.S. citizens resident in Italy who are partners of a U.S. partnership. The exception to the saving clause with respect to social security benefits means that if the United States makes a social security payment to a resident of Italy who is a citizen of both countries, only Italy can tax that payment.

In addition, the saving clause does not apply to the following benefits conferred by one of the countries upon individuals who neither are citizens of that country nor have been admitted for permanent residence in that country. Under this set of exceptions to the saving clause, the specified treaty benefits are available to, for example, an Italian citizen who spends enough time in the United States to be taxed as a U.S. resident but who has not acquired U.S. permanent residence status (i.e., does not hold a "green card"). The benefits that are covered under this set of exceptions are the exemptions from host country tax for certain compensation from government service (Article 19), certain income received by professors or teachers (Article 20), certain income received by students or trainees (Article 21), and certain income of diplomats and consular officials (Article 27).

Article 2. Taxes Covered

The proposed treaty generally applies to the income taxes of the United States and Italy. However, Article 24 (Non-Discrimination) is applicable to all taxes imposed at all levels of government, including State and local taxes. Moreover, Article 26 (Exchange of Information) generally is applicable to all national-level taxes, including, for example, estate and gift taxes.

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

The proposed protocol, like the protocol to the present treaty, provides that 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 under the proposed treaty or any other treaty. Because the insurance excise taxes are covered taxes under the proposed treaty, Italian 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 an Italian insurer reinsures a policy it has written on a U.S. risk with a foreign insurer that is not entitled to a similar exemption under this or a different tax treaty.

In the case of Italy, the proposed treaty applies to the individual income tax (l'imposta sul reddito delle persone fisiche); the corporation income tax (l'imposta sul reddito delle persone giuridiche); and the regional tax on productive activities (l'imposta regionale sulle attivita produttive) (the so-called "IRAP" tax), but only that portion of the IRAP tax that is considered to be an income tax under Article 23 (Relief from Double Taxation). The present treaty covers a local tax rather than this regional tax. Such taxes include those that are collected by means of withholding.

The proposed treaty also contains a rule generally found in U.S. income tax treaties (including the present treaty) which provides that the proposed treaty applies to any identical or substantially similar taxes that may be imposed subsequently in addition to or in place of the taxes covered. The proposed treaty obligates the competent authority of each country to notify the competent authority of the other country of any significant changes in its internal tax laws or of any significant official published materials concerning the application of the proposed treaty, including explanations, regulations, rulings, or judicial decisions. The Technical Explanation states that this requirement relates to changes that are significant to the operation of the proposed treaty.

Article 3. General Definitions

The proposed treaty provides definitions of a number of terms for purposes of the proposed treaty. Certain of the standard definitions found in most U.S. income tax treaties are included in the proposed treaty.

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

A "company" under the proposed treaty is any body corporate or any entity which is treated as a body corporate for tax purposes.

The terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean, respectively, an enterprise carried on by a resident of a treaty country and an enterprise carried on by a resident of the other treaty country. The proposed treaty does not define the term "enterprise." However, despite the absence of a clear, generally accepted meaning, the Technical Explanation states that the term is understood to refer to any activity or set of activities that constitute a trade or business.

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

The U.S. “competent authority” is the Secretary of the Treasury or his delegate. The U.S. competent authority function has been delegated to the Commissioner of Internal Revenue, who has redelegated the authority to the Assistant Commissioner (International). On interpretative issues, the latter acts with the concurrence of the Associate Chief Counsel (International) of the IRS. The Italian “competent authority” is the Ministry of Finance.

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

The term “Italy” means the Italian Republic and includes any area beyond the territorial sea that is designated as an area within which Italy, in compliance with its legislation and in conformity with international law, exercises sovereign rights in respect of the exploration and exploitation of the natural resources of the seabed, the subsoil and the superjacent waters.

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

The proposed treaty defines the term “qualified governmental entity” as any person or body of persons that constitutes a governing body of a treaty country, or of a political or administrative subdivision or local authority of a treaty country. Also defined as a qualified governmental entity is a person that is wholly owned (directly or indirectly) by a treaty country or a political or administrative subdivision or local authority thereof, provided it is organized under the laws of a treaty country, its earnings are credited to its own account with no portion of its income inuring to the benefit of any private person, and its assets vest in the treaty country, political or administrative subdivision or local authority upon dissolution. A qualified governmental entity is also defined to include a pension trust or fund of a person previously described in this paragraph that is constituted and operated exclusively to administer or provide pension benefits described in Article 19 (Government Service). The definitions described in the previous two sentences only apply if the entity does not carry on commercial activities. These definitions are the same as those in the U.S. model. The proposed protocol provides that in the case of the United States, a qualified governmental entity includes the Federal Reserve Banks, the Export-Import Bank, and the Overseas Private Investment Corporation. In the case of Italy, the proposed protocol provides that a qualified governmental entity includes La Banca d’Italia (the Central Bank), L'Istituto per il Commercio con l'Estero (the Foreign Trade Institute), and L'Istituto per l'Assicurazione del Credito all'Esportazione (the Official Insurance Institute for Export Credits). The proposed protocol also provides that a qualified governmental entity includes financial institutions, the capital of which is wholly owned by a treaty country or any state or political or administrative subdivision or local authority as may be agreed from time to time between the competent authorities of both treaty countries.

The proposed treaty also contains the standard provision that, unless the context otherwise requires, all terms not defined in the treaty have the meaning pursuant to the respective tax laws of the country that is applying the treaty.

Article 4. Resident

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

Internal taxation rules

United States

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

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

Italy

Under Italian law, residents are subject to tax on their worldwide income, while nonresident individuals are subject to tax only on income arising in Italy. Individuals are considered to be residents of Italy if their habitual abode is in Italy, if the center of their vital interests is in Italy, or if they are registered for the greater part of the tax period with the Office of Records of the Resident Population.

Companies that are resident in Italy are subject to taxation on their worldwide income. A company that for the greater part of the tax year has its legal seat, place of effective management, or main business purpose in Italy is considered to be resident in Italy. Nonresident companies are subject to corporate income tax on income derived from Italy.

Proposed treaty rules

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

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

The proposed protocol provides special rules to treat as residents of a treaty country certain organizations that generally are exempt from tax in that country. Under these rules, a resident includes a legal person organized under the laws of a treaty country and that is generally exempt from tax in the treaty country because it is established and maintained either (1) exclusively for a religious, charitable, educational, scientific, or other similar purpose; or (2) to provide pensions or other similar benefits to employees pursuant to a plan. The Technical Explanation states that the term "similar benefits" is intended to encompass employee benefits such as health and disability benefits.

The proposed protocol also provides that a qualified governmental entity is a resident of the country where it is established.

The proposed treaty and proposed protocol contain special rules for fiscally transparent entities. Under these rules, the income of a partnership, estate, or trust (or according to the proposed protocol, a fiscally transparent entity) is considered to be the income of a resident of one of the treaty countries only to the extent that such income is subject to tax in that country as the income of a resident, either in its hands or in the hands of its partners or beneficiaries. For example, if a corporation resident in Italy distributes a dividend to an entity treated as fiscally transparent for U.S. tax purposes, the dividend will be considered to be derived by a resident of the United States only to the extent that U.S. tax laws treat one or more U.S. residents (whose status as U.S. residents is determined under U.S. tax laws) as deriving the dividend income for U.S. tax purposes.

The Technical Explanation states that these rules for income derived through fiscally transparent entities apply regardless of where the entity is organized (i.e., in the United States, Italy, or a third country). The Technical Explanation also states that these rules apply even if the entity is viewed differently under the tax laws of the other country. As an example, the Technical Explanation states that income from Italian sources received by an entity organized under the laws of Italy, which is treated for U.S. tax purposes as a corporation and is owned by a U.S. shareholder who is a U.S. resident for U.S. tax purposes, is not considered derived by the shareholder of that corporation, even if under the tax laws of Italy the entity is treated as fiscally transparent. Rather, for purposes of the proposed treaty, the income is treated as derived by the Italian entity.

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

In the case of any person other than an individual that would be a resident of both countries, the proposed treaty requires the competent authorities to endeavor to settle the issue of residence by mutual agreement and to determine the mode of application of the proposed treaty to such person.

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 items of income will be taxed as business profits.

In general, under the proposed treaty, a permanent establishment is a fixed place of business in which the business of an enterprise is wholly or partly carried on. A permanent establishment includes a place of management, a branch, an office, a factory, a workshop, a mine, a quarry, or other place of extraction of natural resources. It also includes a building site or construction or assembly project that continues for more than twelve months. The proposed protocol provides that it also includes a drilling rig or ship used for the exploration or development of natural resources only if it continues for more than twelve months. The present treaty, on the other hand, treats such drilling rigs and ships as permanent establishments if the activity continues for more than 180 days in a twelve month period. The Technical Explanation states that the twelve-month test applies separately to each individual site or project, with a series of contracts or projects that are interdependent both commercially and geographically treated as a single project. The Technical Explanation further states that if the twelve-month threshold is exceeded, the site or project constitutes a permanent establishment as of the first day that work in the country began.

Under the proposed treaty, as under the present treaty, the following activities are deemed not to constitute a permanent establishment: (1) the use of facilities solely for storing, displaying, or delivering goods or merchandise belonging to the enterprise; (2) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for storage, display, or delivery or solely for processing by another enterprise; (3) the maintenance of a fixed place of business solely for the purchase of goods or merchandise or for the collection of information for the enterprise; and (4) the maintenance of a fixed place of business for the enterprise solely for the purpose of advertising, for the supply of information, for scientific research, or for similar activities of a preparatory or auxiliary character.

Under the U.S. model, the maintenance of a fixed place of business solely for any combination of the above-listed activities does not constitute a permanent establishment. The Treasury Explanation states that Italy is unwilling to commit that all or several of the activities described above may be undertaken in combination without constituting a permanent establishment.

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

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

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

Article 6. Income from Immovable Property

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

Under the proposed treaty, income derived by a resident of one country from immovable property situated in the other country may be taxed in the country where the property is located. This rule is consistent with the rules in the U.S. and OECD models. For this purpose, income from immovable property includes income from agriculture or forestry.

The term "immovable property" ("real property") has the meaning which it has under the law of the country in which the property in question is situated.[6] The proposed treaty specifies that the term in any case includes property accessory to immovable property; livestock and equipment used in agriculture and forestry; rights to which the provisions of general law respecting landed property apply; usufructs of immovable property; and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources, and other natural resources. Ships, boats, and aircraft are not considered to be immovable property.

The proposed treaty specifies that the country in which the property is situated also may tax income derived from the direct use, letting, or use in any other form of immovable property. The rules of Article 6, permitting source country taxation, also apply to the income from immovable property of an enterprise and to income from immovable property used for the performance of independent personal services.

Unlike the U.S. model, the proposed treaty does not provide that residents of a treaty country that are liable for tax in the other treaty country on income from immovable property situated in such other treaty country may elect to compute the tax on such income on a net basis. However, U.S. internal law provides for such a net basis election in the case of income of a foreign person from real property (Code secs. 871(d) and 882(d)). The Technical Explanation states that Italian internal law contains a provision that approximates net basis taxation for income from real property.

Article 7. Business Profits

Internal taxation rules

United States

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

[6] In the case of the United States, the term is defined in Treas. Reg. sec. 1.897–1(b).

tively connected with the conduct of a trade or business within the United States.

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

Foreign-source income generally is effectively connected income only if the foreign person has an office or other fixed place of business in the United States and the income is attributable to that place of business. Only three types of foreign-source income are considered to be effectively connected income: rents and royalties for the use of certain intangible property derived from the active conduct of a U.S. business; certain dividends and interest either derived in the active conduct of a banking, financing or similar business in the United States or received by a corporation the principal business of which is trading in stocks or securities for its own account; and certain sales income attributable to a U.S. sales office. Special rules apply for purposes of determining the foreign-source income that is effectively connected with a U.S. business of an insurance company.

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

Italy

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

Proposed treaty limitations on internal law

Under the proposed treaty, business profits of an enterprise of one of the countries are taxable in the other country only to the extent that they are attributable to a permanent establishment in the other country through which the enterprise carries on business.

This is one of the basic limitations on a country's right to tax income of a resident of the other country. The rule is similar to those contained in the U.S. and OECD models.

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

In computing taxable business profits of a permanent establishment, the proposed treaty provides that deductions are allowed for expenses, wherever incurred, which are attributable to the activities of the permanent establishment. These deductions include a reasonable allocation of executive and general administrative expenses. The Technical Explanation states that as in the present treaty, but unlike the U.S. model, the proposed treaty does not explicitly state that the expenses that may be considered to be incurred for the purposes of the permanent establishment are expenses for research and development, interest, and other similar expenses. The Technical Explanation, however, states that Italy accepts the principle of a reasonable allocation of expenses (such as in Treas. Reg. sections 1.861–8 and 1.882–5). The Committee believes that it is appropriate to apply reasonable allocation methods for these purposes.

The Technical Explanation states that deductions will not be allowed for expenses charged to a permanent establishment by another unit of the enterprise. Thus, a permanent establishment may not deduct a royalty deemed paid to the head office.

Business profits are not attributed to a permanent establishment merely by reason of the purchase of goods or merchandise by the permanent establishment for the enterprise. 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 a profit element in its purchasing activities.

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

The proposed treaty provides that, for purposes of the taxation of business profits, income may be attributable to a permanent establishment (and therefore may be taxable in the source country) even if the payment of such income is deferred until after the permanent establishment or fixed base has ceased to exist. This rule incorporates into the proposed treaty the rule of Code section 864(c)(6) described above. This rule applies with respect to business profits (Article 7, paragraphs 1 and 2), dividends (Article 10, paragraph 4), interest (Article 11, paragraph 5), royalties (Article 12, paragraph 5), capital gains (Article 13, paragraph 2), independent personal services income (Article 14), and other income (Article 22, paragraph 2).

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

Article 8. Shipping and Air Transport

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

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

Like the present treaty, the proposed treaty provides that profits 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" is defined in Article 3(1)(d) (General Definitions) as any transport by a ship or aircraft, except when the transport is solely between places in the other treaty country.

The proposed protocol provides that profits from the operation of ships or aircraft in international traffic include profits derived from the rental of ships or aircraft on a full (time or voyage) basis (i.e., with crew). Like the present treaty, it also includes profits from the rental of ships or aircraft on a bareboat basis (i.e., without crew) if such rental activities are incidental to the activities from the operation of ships or aircraft in international traffic. Although not provided for in the proposed treaty, the Technical Explanation states that profits derived by an enterprise from the inland transport of property or passengers within either treaty country are treated as profits from the operation of ships or aircraft in international traffic if such transport is undertaken as part of international traffic by the enterprise.

As under the U.S. model, the proposed protocol provides that profits of an enterprise of a country from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) used for the transport of goods or merchandise in international traffic is taxable only in that country.

As under the U.S. model, the shipping and air transport provisions of the proposed treaty apply to profits derived from participation in a pool, joint business, or international operating agency.

This refers to various arrangements for international cooperation by carriers in shipping and air transport.

The Technical Explanation states that income from the rental of ships, aircraft, or containers which is not exempt from source country tax under this article is taxable as royalty income (Article 12) or as business profits if attributable to a permanent establishment (Article 7). Under the royalty article, the rental income is considered to have its source in Italy if the payer is a resident of Italy or if the rental payment is for the use of the property in Italy. The Technical Explanation also states that certain non-transport activities that are an integral part of the services performed by a transport company are understood to be covered by this article of the proposed treaty.

The proposed protocol provides, like the present treaty, that profits which a U.S. national not resident in Italy or which a U.S. corporation derives from operating ships documented or aircraft registered under U.S. law will be exempt from tax in Italy. The Technical Explanation states that this exception applies regardless of whether the income was derived from the operation of ships or aircraft in international traffic.

The proposed protocol provides that if a U.S. state or local government imposes tax on the profits of Italian enterprises from the operation of ships or aircraft in international traffic, Italy may impose its regional tax on productive activites (l'imposta regionale sulle attivita produttive) (i.e., the IRAP tax) on the profits of U.S. enterprises from such activities, notwithstanding the provisions of Article 2 (Taxes Covered) and this article of the proposed treaty.

Article 9. Associated Enterprises

The proposed treaty, like most other U.S. tax treaties, contains an arm's-length pricing provision. The proposed treaty recognizes the right of each country to make an allocation of profits to an enterprise of that country in the case of transactions between related enterprises, if conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises. In such a case, a country may allocate to such an enterprise the profits which it would have accrued but for the conditions so imposed. This treatment is consistent with the U.S. model.

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

Under the proposed treaty, when a redetermination of tax liability has been made by one country under the provisions of this article, the other country will make an appropriate adjustment to the amount of tax paid in that country on the redetermined income. In making such adjustment, due regard is to be given to other provisions of the proposed treaty and proposed protocol. Any such adjustment is to be made only in accordance with the mutual agreement procedures of the proposed treaty. The proposed treaty's saving clause retaining full taxing jurisdiction in the country of residence or citizenship does not apply in the case of such adjustments. Accordingly, internal statute of limitations provisions do not prevent the allowance of appropriate correlative adjustments.

The proposed protocol provides that the proposed treaty does not limit any provisions of either country's internal law which permit the distribution, apportionment, or allocation of income, deductions, credits, or allowances between persons owned or controlled directly or indirectly by the same interest when necessary in order to prevent evasion of taxes or to clearly reflect the income of any person. Any such adjustments are permitted even if they are different from, or go beyond, those specifically authorized by this article, as long as they are in accord with general arm's length principles.

Article 10. Dividends

Internal taxation rules

United States

The United States generally imposes a 30-percent tax on the gross amount of U.S.-source dividends paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In such a case, the foreign recipient is subject to U.S. tax on such dividends on a net basis at graduated rates in the same manner that a U.S. person would be taxed.

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

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

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

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

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

U.S. internal law also generally treats a regulated investment company ("RIC") as both a corporation and a conduit for income tax purposes. The purpose of a RIC is to allow investors to hold a diversified portfolio of securities. Thus, the holder of stock in a RIC may be characterized as a portfolio investor in the stock held by the RIC, regardless of the proportion of the RIC's stock owned by the dividend recipient.

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." The dividend equivalent amount is the corporation's earnings and profits which are attributable to its income that is effectively connected with its U.S. trade or business, decreased by the amount of such earnings that are reinvested in business assets located in the United States (or used to reduce liabilities of the U.S. business), and increased by any such previously reinvested earnings that are withdrawn from investment in the U.S. business. The dividend equivalent amount is limited by (among other things) aggregate earnings and profits accumulated in taxable years beginning after December 31, 1986.

Italy

Italy generally imposes a withholding tax on dividend payments to nonresidents at a rate of 27 percent. However, nonresident individuals may claim reimbursement of up to two-thirds of the withholding tax and nonresident companies may claim reimbursement of up to four-ninths of the withholding tax, but only if the respective nonresident can show that residence-country tax was paid on the dividend income. There is no branch remittance tax.

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 company that has owned more than 50 percent of the voting stock during the 12-month period ending on the date of dividend declaration. Furthermore, the rate of tax is limited to 10 percent if the beneficial owner is a company that has owned at least 10 percent but not more than 50 percent of the voting stock during the 12-month period ending on the date of the dividend declaration. In order for the 5 or 10 percent rates to apply under the present treaty, not more than 25 percent of the gross income of the payor corporation may be derived from interest or dividends (other than interest or dividends derived in the conduct of a banking or finance business and interest or dividends received from subsidiary companies).

Under the proposed treaty, dividends paid by a resident of a treaty country and beneficially owned by a resident of the other country may be taxed in such other country. Dividends paid by a resident of a treaty country and beneficially owned by a resident of the other country may also be taxed by the country in which the payor is resident, but the rate of such tax is limited. Under the proposed treaty, source country taxation (i.e., taxation by the country in which the payor is resident) generally is limited to 5 percent of the gross amount of the dividend if the beneficial owner of the dividend is a company which owns at least 25 percent of the voting stock of the payor company for a twelve-month period ending on the date the dividend is declared. The source country dividend withholding tax generally is limited to 15 percent of the gross amount of the dividends beneficially owned by residents of the other country 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 defines a "dividend" to include income from shares, "jouissance" shares or "jouissance" rights, mining shares, founder's shares, or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subject to the same tax treatment as income from shares by the internal laws of the treaty country of which the company making the distribution is a resident.

The proposed treaty's reduced rates of source country tax on dividends do not apply if the dividend recipient carries on business through a permanent establishment (or fixed base, in the case of an individual who performs independent personal services) in the source country and the dividends are effectively connected to the permanent establishment (or fixed base). In such a case, such dividends are taxable in the source country according to its own laws. The proposed protocol provides that such dividends may be taxed as either business profits (Article 7) or as income from the performance of independent services (Article 14), as the case may be. Under the proposed treaty, these rules also apply if the permanent establishment or fixed base no longer exists when the dividends are paid but such dividends are attributable to the former permanent establishment or fixed base.

Where a company that is a resident of one country derives profits or income from the other treaty country, the proposed treaty provides that such other country cannot impose any tax on the dividends paid, or undistributed profits earned, by such resident. Thus, the United States cannot impose its "secondary" withholding tax on dividends paid by an Italian company out of its earnings and profits from the United States. An exception to this provision is provided in cases where the dividends are paid to a resident of the other treaty country or are effectively connected to a permanent establishment or a fixed base situated in such other treaty country. This rule does not prevent a country from imposing a branch profits tax as provided below. This rule also applies even if the dividends paid or undistributed profits consist wholly or partly of profits arising in such other country.

Unlike the present treaty, the proposed treaty permits the imposition of a branch profits tax, but limits the rate of such tax to 5 percent. The branch profits tax may be imposed on a company that is a resident of a treaty country and that has a permanent establishment in the other treaty country or is subject to tax in the other treaty country on a net basis on its income from immovable property (Article 6) or capital gains (Article 13). Such tax may be imposed only on the portion of the business profits attributable to such permanent establishment, or the portion of such immovable property income or capital gains, that represents the "dividend equivalent amount" (in the case of the United States) or an analogous amount (in the case of Italy). The Technical Explanation states that the term "dividend equivalent amount" has the same meaning that it has under Code section 884, as amended from time to time, provided that the amendments are consistent with the purpose of the branch profits tax.

The proposed treaty provides an exemption from source country tax for dividends paid by a corporation that is a resident of one country to a qualified governmental entity (as defined in Article 3(1)(i)) that is resident in the other country. This exemption from source country tax only applies if the governmental entity owns (directly or indirectly) less than 25 percent of the voting stock of the company paying the dividends. This threshold is different than the corresponding rule in the U.S. model, which provides that the qualified governmental entity may not "control" the dividend paying company.

Under the proposed treaty, dividends paid by a U.S. RIC are eligible only for the 15-percent rate, regardless of the beneficial owner's percentage ownership in such entity. Dividends paid by a U.S. REIT are not eligible for the 5-percent rate. Moreover, such REIT dividends are eligible for the 15-percent rate only if an individual beneficially owning the dividends holds no more than a 10-percent interest in the U.S. REIT; the dividends are paid with respect to a class of stock that is publicly traded and the beneficial owner of the dividends owns no more than 5 percent of any class of the REIT's stock; or the beneficial owner of the dividends owns no more than 10 percent of the REIT and such REIT is also diversified. Otherwise, dividends paid by a U.S. REIT are subject to U.S. taxation at the full 30-percent statutory rate. The Technical Explanation states that, for these purposes, a REIT is considered diversified if the value of no single interest in the REIT's real property exceeds 10 percent of the REIT's total interest in real property.

The proposed treaty provides a "main purpose" test that is not specifically included in the dividends articles of the U.S. model or OECD model. Under this rule, the proposed treaty's reduced rates of tax on dividends do not apply if the main purpose, or one of the main purposes, for the creation or assignment of shares or other rights in respect of which dividends are paid is to take advantage of the dividends article of the proposed treaty. The Technical Explanation states that it is intended that the provisions of this article will be self-executing, but the tax authorities of one of the treaty countries, on review, may deny the benefits of the reduced rate of tax on dividends. In addition, the Technical Explanation states that the competent authorities of both of the treaty countries may together agree that this standard has been met in a particular case or with respect to a type of transaction entered into by a number of taxpayers.

Article 11. Interest

Internal taxation rules

United States

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

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

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

Italy

Italian-source interest payments to nonresidents generally are subject to withholding tax at a rate of 27 percent. However, no withholding tax is assessed on interest paid to a U.S. resident with respect to: (1) public bonds; (2) private bonds issued by banks and listed companies; and (3) deposits or current accounts. Interest paid with respect to private bonds having at least an 18-month maturity that are issued by other than a bank or listed company is subject to withholding tax at a rate of 12.5 percent.

Proposed treaty limitations on internal law

The present treaty generally limits source country tax to a maximum rate of 15 percent on interest derived by a resident of the other country. The present treaty also provides for a compete withholding exemption for interest derived by a treaty country (or a wholly-owned instrumentality thereof), or a treaty country resident with respect to debt obligations guaranteed or insured by such country (or instrumentality).

The proposed treaty provides that interest arising in one of the countries and beneficially owned by a resident of the other country generally may be taxed by both countries. This is contrary to the position of the U.S. model which provides for an exemption from source country tax for interest beneficially owned by a resident of the other country.

The proposed treaty limits the rate of source country tax that may be imposed on interest income. Under the proposed treaty, if the beneficial owner of interest is a resident of the other country, the source country tax on such interest generally may not exceed 10 percent of the gross amount of such interest.

The proposed treaty provides for a complete exemption from source country withholding tax in the case of interest arising in a treaty country if the interest is (1) beneficially owned by a resident of the other country that is a qualified governmental entity owning (directly or indirectly) less than 25 percent of the capital of the person paying the interest, (2) paid with respect to debt obligations guaranteed or insured by a qualified governmental entity of that other country and beneficially owned by a resident of such other country, (3) paid or accrued with respect to a sale on credit of goods, merchandise, or services provided by one enterprise to another enterprise; or (4) paid or accrued in connection with the sale on credit of industrial, commercial, or scientific equipment.

The proposed treaty defines the term "interest" as income from government securities, bonds, or debentures, whether or not secured by a mortgage and whether or not carrying a right to participate in profits. It also includes debt claims of every kind as well as all other income subject to the same tax treatment as income from money lent under the tax law of the source country. The proposed protocol provides that, in the case of the United States, an excess inclusion with respect to a residual interest in a U.S. REMIC may be taxed as interest in accordance with each country's respective internal laws. The proposed treaty provides that the term "interest" does not include amounts treated as dividends under Article 10 (Dividends).

The proposed treaty's reductions in source country tax on interest do not apply if the beneficial owner carries on business in the source country through a permanent establishment located in that country (or fixed base, in the case of an individual who performs independent personal services) and the debt claim in respect of which the interest is paid is effectively connected to that permanent establishment (or fixed base). In such a case, such interest is taxable in the source country according to its own laws. The proposed protocol provides that such interest may be taxed as either business profits (Article 7) or as income from the performance of independent services (Article 14), as the case may be. These rules also apply if the permanent establishment or fixed base no longer exists when the interest is paid but such interest is attributable to the former permanent establishment or fixed base.

The proposed treaty provides that interest is treated as arising in a treaty country if the payor is the treaty country or its political subdivisions or local authorities, or is a resident of that country.[7] If, however, the interest expense is borne by a permanent establishment or a fixed base, the interest will have as its source the country in which the permanent establishment or fixed base is located, regardless of the residence of the payor. Thus, for example, if a French resident has a permanent establishment in Italy and that French resident incurs indebtedness to a U.S. person, the interest on which is borne by the Italian permanent establishment, the interest would be treated as having its source in Italy.

The proposed treaty addresses the issue of non-arm's-length interest charges between related parties (or parties otherwise having a special relationship) by providing that the amount of interest for purposes of applying this article is the amount of interest that would have been agreed upon by the payor and the beneficial owner in the absence of the special relationship. Any amount of interest paid in excess of such amount is taxable according to the laws of each country, taking into account the other provisions of the proposed treaty. For example, excess interest paid by a subsidiary corporation to its parent corporation may be treated as a dividend under local law and thus be subject to the provisions of Article 10 (Dividends).

In the case of the United States, the proposed treaty permits the imposition of the U.S. branch level interest tax on an Italian corporation, but limits the rate of such tax to 10 percent. The U.S. tax imposed on the Italian corporation is the excess, if any, of (1) the interest deductible in computing the profits of the Italian corporation that either are attributable to a permanent establishment or subject to tax under Article 6 (Income from Immovable Property) or Article 13 (Capital Gains) over (2) the interest paid by the permanent establishment or trade or business.

The proposed treaty also provides a main purpose test similar to that for dividends (Article 10) under which the provisions with respect to interest will not apply if the main purpose, or one of the

[7] This is consistent with the source rules of U.S. law, which provide as a general rule that interest income has as its source the country in which the payor is resident.

main purposes, for the creation or assignment of the debt claim in respect of which interest is paid is to take advantage of the interest article of the proposed treaty.

Article 12. Royalties

Internal taxation rules

United States

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

Italy

Royalties paid to nonresidents are subject to a 30 percent withholding tax, which is generally applied to 75 percent of the gross royalty payment, resulting in an effective rate of 22.5 percent.

Proposed treaty limitations on internal law

The present treaty provides that royalties 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 10 percent. However, the rate of tax is limited to 5 percent if the royalty is in respect of payments received as consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work. In addition, the rate of tax is limited to 7 percent if the royalties are derived with respect to tangible personal property. Furthermore, the rate of tax is limited to 8 percent if the royalty is in respect of payments received as consideration for the use of, or the right to use, motion pictures and films, tapes or other means of reproduction used for radio or television broadcasting.

The proposed treaty provides that royalties arising in a treaty country and beneficially owned by a resident of the other country may be taxed by that other country. In addition, the proposed treaty allows the country where the royalties arise (the "source country") to tax such royalties. However, if the beneficial owner of the royalties is a resident of the other country, the source country tax generally may not exceed 8 percent of the gross royalties. This maximum 8-percent rate is higher than the rate permitted under most U.S. treaties and the U.S. and OECD models, but is generally lower than the maximum rate under the present treaty. The U.S. and OECD models generally exempt royalties from source country taxation. The proposed treaty further provides that the source country tax on certain amounts treated as royalties may not exceed 5 percent of the gross royalties. This 5-percent limitation applies to royalties for the use of (or the right to use) computer software or industrial, commercial, or scientific equipment. Like the present treaty, but unlike the U.S. model, such rental income is considered to be a royalty.

Unlike the present treaty, the proposed treaty provides a complete exemption from source country tax for royalties beneficially owned by a resident of the other country for the use of (or right to use) a copyright of literary, artistic, or scientific work (excluding royalties for computer software, motion pictures, films, tapes, or other means of reproduction used for radio or television broadcasting) if such resident is the beneficial owner of the royalties.

For purposes of the proposed treaty, the term “royalties” means payment of any kind received as consideration for the use of, or the right to use, copyrights of literary, artistic, or scientific work (including computer software, motion pictures, films, tapes, or other means of reproduction used for radio or television broadcasting), patents, trademarks, designs or models, plans, secret formulae, processes, or other like rights or properties. The term also includes consideration for the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial, or scientific experience. According to the Technical Explanation, it is understood that whether payments with respect to computer software are treated as royalties or as business profits will depend on the facts and circumstances of the particular transaction. The Technical Explanation states that it is understood that payments with respect to transfers of “shrink wrap” computer software will be treated as business profits and not as royalties. The Technical Explanation also states that, with respect to the United States, gains derived from the sale of any right or property that would give rise to royalties is also considered to be royalty income, but only to the extent that such gain is contingent on the productivity, use, or further disposition thereof.

The reduced rates of source country tax do not apply where the recipient carries on business through a permanent establishment (or fixed base in the case of an individual who performs independent personal services) in the source country, and the royalties are effectively connected to the permanent establishment (or fixed base). In such a case, such royalties are taxable in the source country according to its own laws. The proposed protocol provides that such royalties may be taxed as either business profits (Article 7) or as income from the performance of independent services (Article 14), as the case may be. These rules also apply if the permanent establishment or fixed base no longer exists when the royalties are paid but such royalties are attributable to the former permanent establishment or fixed base.

The proposed treaty provides source rules for royalties which differ, in part, from those provided under U.S. internal law. Royalties are deemed to arise within a country if the payor is a resident of that country, or is one of the treaty countries or its political subdivisions or local authorities. If, however, the royalty expense is borne by a permanent establishment or fixed base that the payor has in Italy or the United States, the royalty has as its source the country in which the permanent establishment or fixed base is located, regardless of the residence of the payor. Thus, for example, if a French resident has a permanent establishment in Italy and that French resident pays a royalty to a U.S. person which is attributable to the Italian permanent establishment, then the royalty would be treated as having its source in Italy. The proposed treaty provides that notwithstanding the foregoing rules, royalties with respect to the use of, or right to use, rights or property within a treaty county may be deemed to arise within that country. Thus, consistent with U.S. internal law, the United States may treat royalties with respect to the use of property in the United States as U.S. source income.

The proposed treaty addresses the issue of non-arm's-length royalties between related parties (or parties otherwise having a special relationship) by providing that the amount of royalties for purposes of applying this article is the amount that would have been agreed upon by the payor and the beneficial owner in the absence of the special relationship. Any amount of royalties paid in excess of such amount is taxable according to the laws of each country, taking into account the other provisions of the proposed treaty. For example, excess royalties paid by a subsidiary corporation to its parent corporation may be treated as a dividend under local law and thus be subject to the provisions of Article 10 (Dividends).

As in the case of dividends (Article 10) and interest (Article 11), the proposed treaty includes a main purpose test under which the royalty provision will not apply if the main purpose, or one of the main purposes, for the creation or assignment of rights in respect of which royalties are paid is to take advantage of the proposed treaty's royalty article.

Article 13. Capital Gains

Internal taxation rules

United States

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

Italy

Nonresident companies are subject to the corporate income tax (37 percent) on capital gains from immovable property, but only if held for 5 years or less. Capital gains recognized by nonresident companies from the sale of shares or other participations in Italian resident companies are generally subject to a 27 percent tax rate. However, if the amount of participations sold during a 12-month period does not exceed either (1) 2 percent of voting power or 5 percent of capital (in the case of listed companies) or (2) 20 percent of voting power or 25 percent of capital (in all other cases), then such gains are subject to a 12.5 percent tax rate.

Proposed treaty limitations on internal law

The proposed treaty specifies rules governing when a country may tax gains from the alienation of property by a resident of the other country. The rules are generally consistent with those contained in the U.S. model.

Under the proposed treaty, gains derived by a resident of one treaty country from the alienation of immovable property situated in the other country may be taxed in the country where the property is situated. The proposed protocol provides that with respect to the United States, the term "immovable property" includes a United States real property interest. Such property is deemed to be situated in the United States for purposes of this article. In the case of Italy, immovable property includes (1) immovable property referred to in Article 6 (Income from Immovable Property), (2) shares (or comparable interests) in a company (or other body of persons) the assets of which consist wholly or principally of real property situated in Italy, and (3) an interest in an estate of a deceased individual, the assets of which consist wholly or principally of real property situated in Italy. Such property is deemed to be situated in Italy for purposes of this article.

The proposed treaty contains a standard provision which permits a country to tax the gain from the alienation of movable property that forms a part of the business property of a permanent establishment located in that country, or that pertains to a fixed base in that country for the purpose of performing independent personal services. This rule also applies to gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or such a fixed base. This rule also applies if the permanent establishment or fixed base no longer exists when the gains are recognized but such gains relate to the former permanent establishment or fixed base.

The proposed treaty provides that gains derived by an enterprise of one of the treaty countries from the alienation of ships or aircraft operated in international traffic (or movable property pertaining to the operation or use of ships, aircraft, or containers) are taxable only in such country. The proposed protocol provides that this rule also applies to (1) gains from the sale of containers (including trailers, barges, and related equipment for the transport of containers) used for the transport in international traffic of goods or merchandise; and (2) gains from the sale of ships or aircraft rented on a full basis or gains from the sale of ships or aircraft rented on a bareboat basis if, in the latter case, the rental profits are incidental to other profits from the operation of ships or aircraft in international traffic.

Gains from the alienation of any property other than that discussed above is taxable under the proposed treaty only in the country where the person disposing of the property is resident.

Article 14. Independent Personal Services

Internal taxation rules

United States

The United States taxes the income of a nonresident alien individual 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 a trade or business within the United States.

Under the Code, the income of a nonresident alien individual 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 the following criteria are met: (1) the individual is not in the United States for over 90 days during the taxable year, (2) the compensation does not exceed $3,000, and (3) the services are performed as an employee of, or under a contract with, a foreign person not engaged in a trade or business in the United States, or are performed for a foreign office or place of business of a U.S. person.

Italy

Nonresident individuals are subject to a withholding tax of 30 percent on self-employment income.

Proposed treaty limitations on internal law

The proposed treaty limits the right of a country to tax income from the performance of personal services by a resident of the other country. Under the proposed 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.

Like the present treaty, the proposed treaty provides that income from the performance of professional services in an independent capacity by a resident of one country is exempt from tax in the country where the services are performed (the source country) unless the individual performing the services has a fixed base regularly available to him or her in the source country for the purpose of performing the services.[8] In that case, the source country is permitted to tax only that portion of the individual's income which is attributable to the fixed base.

The term "professional services in an independent capacity" includes, but is not limited to, scientific, literary, artistic, educational, and teaching activities as well as independent activities of physicians, lawyers, engineers, architects, dentists, and accountants.

Article 15. Dependent Personal Services

Under the proposed treaty, salaries, wages, 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 by the country of residence if three requirements are met: (1) the individual is present in the source country for not more than 183 days in the fiscal year; (2) the individual is paid by, or on behalf of, an employer who 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 are the same as the rules of the U.S. model and the OECD model.

The proposed treaty contains a special rule that permits remuneration derived by a resident of one country in respect of employ-

[8] The Technical Explanation states that it is understood that the concept of a fixed base is similar to the concept of a permanent establishment.

ment regularly exercised as a member of the crew of a ship or aircraft operated in international traffic by an enterprise of the other country to be taxed in that other country. A similar rule is included in the OECD model. U.S. internal law does not impose tax on such income of a nonresident alien, even if such person is employed by a U.S. entity.

This article is subject to the provisions of the separate articles covering directors' fees (Article 16), pensions, social security, annuities, alimony, and child support payments (Article 18), government service income (Article 19), income of professors and teachers (Article 20), and income of students and trainees (Article 21).

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 that is a resident of the other country is taxable in that other country. Like the U.S. model, the proposed protocol provides that the country of the company's residence may tax the remuneration of nonresident directors, but only with respect to remuneration for services performed in that country.

Article 17. Artistes and Athletes

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

Under the proposed treaty, income derived by an entertainer or athlete who is a resident of one country from his or her personal activities as such in the other country may be taxed in the other country if the amount of the gross receipts derived by him or her from such activities exceeds $20,000 or its equivalent in Italian currency, or such entertainer or athlete is present in the other country for more than 90 days during the fiscal year. The $20,000 threshold includes reimbursed expenses. Under this rule, if an Italian entertainer or athlete maintains no fixed base in the United States and performs (as an independent contractor) for one day of a taxable year in the United States for total compensation of $10,000, the United States could not tax that income. If, however, that entertainer's or athlete's total compensation were $30,000 (or if the individual was present in the United States for more than 90 days), the full amount would be subject to U.S. tax.

The proposed treaty provides that where income in respect of activities exercised by an entertainer or athlete in his or her capacity as such accrues not to the entertainer or athlete but to another person, that income is taxable by the country in which the activities are exercised unless it is established that neither the entertainer or athlete nor persons related to him or her participated directly or indirectly in the profits of that other person in any manner, including the receipt of deferred remuneration, bonuses, fees, dividends, partnership distributions, or other distributions. This provision applies notwithstanding the provisions of the business profits and personal service articles (Articles 7, 14, and 15). This provision prevents highly-paid entertainers and athletes from avoiding tax in the country in which they perform by, for example, routing the compensation for their services through a third entity such as a personal holding company or a trust located in a country that would not tax the income.

Article 18. Pensions, Etc.

Under the proposed treaty, pensions and other similar remuneration derived and beneficially owned by a resident of either country in consideration of past employment is subject to tax only in the recipient's country of residence. The Technical Explanation states that the provision is intended to apply to both periodic or lump sum payments. This rule is subject to the provisions of Article 19 (Government Service) with respect to pensions. The Technical Explanation indicates that it is understood that the United States may require a U.S. resident who receives a distribution from an Italian pension plan to include the entire distribution in the recipient's taxable income under the general residence-based rule above regardless of the fact that Italy may have previously imposed a tax on the Italian pension plan with respect to earnings and accretions.

Notwithstanding the general residence-based rule above, if a resident of one country becomes a resident of the other country, lump-sum payments or severance payments (indemnities) that are received after the change in residency are taxable only in the original country of residency. This exception only applies to amounts that are paid with respect to employment exercised in the original country of residence and only while such person was a resident thereof. The term "severance payments (indemnities)" includes any payment made by reason of the termination of any office or employment of a person. The Technical Explanation states that this provision is intended to prevent potential abuses of the general pension rule described above. The Technical Explanation states that, for example, Italian law requires Italian employers to make certain lump-sum retirement payments to employees upon their retirement. The Technical Explanation notes that absent this provision, an employee resident in Italy (or the United States) who anticipates receiving such a payment might establish residence in the United States (or in Italy) in order to obtain more favorable U.S. (Italian) tax treatment under the general rule.

Like the present treaty, the proposed treaty provides that payments made by one of the countries under the provisions of the social security or similar legislation of the country to a resident of the other country are taxable only by the country of residence. 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 term "similar legislation" is intended to include U.S. tier 1 Railroad Retirement benefits.

The proposed treaty provides that annuities are taxed only in the country of residence of the individual who beneficially derives them. The term "annuities" is defined for purposes of this provision as a stated sum paid periodically at stated times during life or during a specified number of years, under an obligation to make the payments in return for adequate and full consideration in money or money's worth (other than services rendered).

Under the proposed treaty, alimony and child support payments paid by a resident of one country to a resident of the other country will be taxable only in the country of residence of the recipient. However, if the person making such payments is not entitled to a deduction for such payments in his or her country of residence, such payments are not taxable in either treaty country. For this purpose, the term "alimony" means periodic payments made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support, which payments are taxable to the recipient under the laws of the country of residence. The term "child support" means periodic payments for the support of a minor child made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support.

The proposed treaty includes special rules addressing the treatment of cross-border pension contributions. Under the proposed treaty, if an individual who is a member of a pension plan established and recognized under the law of one country performs personal services in the other country, contributions made by the individual to the plan during the period he or she performs such personal services are deductible in computing his or her taxable income in the other country. Similarly, payments made to the plan by or on behalf of his or her employer during such period are not treated as part of his or her taxable income and are allowed as a deduction in computing the employer's profits in the other country. However, these rules apply only if (1) contributions were made by or on behalf of the individual to the plan (or to a similar plan for which this plan is substituted) immediately before he or she visited the other country, and (2) the competent authority of the other country has agreed that the plan generally corresponds to a pension plan recognized for tax purposes by that country. Moreover, the benefits provided under these rules will not exceed the benefits that would be allowed by the other country to its residents for contributions to a pension plan recognized for tax purposes by that country. The proposed protocol provides that in the case of Italy, the term "pension plan" means "fondi pensione."

Article 19. Government Service

Under the proposed treaty, remuneration, other than a pension, paid by a treaty country or one of its political or administrative subdivisions or local authorities to an individual for services rendered to the payor generally is taxable only by that country. 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 by an individual who is a resident of that country and who (1) is also a national of only that country or (2) did not become a resident of that country solely for the purpose of rendering the services. Like the present treaty, if the spouse or dependent child of an individual who under this provision is taxable only in the paying country also performs government functions in the other country, the proposed treaty provides that remuneration for those functions is taxable only in the paying country, provided that the spouse or child is not a national of the other country.

The proposed treaty provides that 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 by that country. Such a pension is taxable only by the other country, however, if the individual is a resident and national of that other country. Social security benefits in respect of government service are subject to Article 18 (Pensions, Etc.) and not this article.

The proposed protocol provides that it is understood that the competent authorities of the treaty countries may, by mutual agreement, apply the rules described above to employees of organizations that perform functions of a governmental nature. The Technical Explanation states that it is anticipated that these rules will apply to, in the case of the United States, employees of the Federal Reserve Banks, the Export-Import Bank, and the Overseas Private Investment Corporation and, in the case of Italy, employees of the Central Bank, the Foreign Trade Institute, and the Official Insurance Institute for Export Credits.

If a country or one of its political subdivisions or local authorities is carrying on a business, the provisions of Articles 14 (Independent Personal Services), 15 (Dependent Personal Services), 16 (Directors' Fees), 17 (Artistes and Athletes), or 18 (Pensions, Etc.) will apply to remuneration and pensions for services rendered in connection with that business.

Article 20. Professors and Teachers

The treatment provided to professors and teachers under the proposed treaty generally corresponds to the treatment provided under the present treaty.

Under the proposed treaty, a professor or teacher who visits the other country (the host country) for a period not expected to exceed two years for the purpose of teaching or conducting research at a university, college, school, or other recognized educational institution, or at a medical facility primarily funded from governmental sources, and who immediately before that visit is, or was a resident of the other treaty country, generally is exempt from host country tax on his or her remuneration from such teaching or research activities. This treaty benefit applies for a period not exceeding two years. This exemption does not apply to income from research undertaken not in the general interest but primarily for the private benefit of a specific person or persons. The proposed protocol provides that for purposes of this article, the term "recognized educational institution" means, in the case of the United States, an accredited educational institution. An educational institution is considered to be accredited if it is accredited by an authority that generally is responsible for the accreditation of institutions in the particular field of study.

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

Article 21. Students and Trainees

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

Under the proposed treaty, a student or business apprentice (trainee) who visits a country (the host country) for the purpose of his or her education at a recognized educational institution or for training, and who immediately before that visit is, or was a resident of the other treaty country, generally is exempt from host country tax on payments he or she receives for the purpose of such maintenance, education, or training; provided, however, that such payments arise outside the host country. The proposed protocol provides that for purposes of this article, the term "recognized educational institution" means, in the case of the United States, an accredited educational institution. An educational institution is considered to be accredited if it is accredited by an authority that generally is responsible for the accreditation of institutions in the particular field of study. The Technical Explanation states that a payment generally is considered to arise outside the host country if the payer is located outside the host country.

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

Article 22. Other Income

This article is a catch-all provision intended to cover items of income not specifically covered in other articles, and to assign the right to tax income from third countries to either the United States or Italy. As a general rule, items of income not otherwise dealt with in the proposed treaty which are derived by residents of one of the countries are taxable only in the country of residence. This rule is similar to the rules in the U.S. and OECD models.

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

The general rule just stated does not apply to income (other than income from immovable property as defined in Article 6) 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 performs independent personal services in the other country from a fixed base, and the income is effectively connected to such permanent establishment or fixed base. In such a case, the income is taxable in the source country according to its laws. The proposed protocol states that the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, may apply. Such exception also applies where the income is received after the permanent establishment or fixed base is no longer in existence, but the income is attributable to the former permanent establishment or fixed base.

The proposed treaty contains a main purpose test similar to that provided with respect to the dividends, interest, and royalties articles (Articles 10, 11 and 12). The Technical Explanation states that, like those articles, the other income article is intended to be self-executing. However, the tax authorities, on review, may deny the benefits of the article in cases in which the main purpose, or one of the main purposes, for the creation or assignment of the rights in respect of which income is paid is to take advantage of the article.

Article 23. Relief From Double Taxation

Internal taxation rules

United States

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

Italy

Italian double tax relief is allowed through a foreign tax credit. Italian foreign tax credits are limited to the lesser of the foreign tax paid or the Italian tax that relates (based on a ratio of foreign income to total income) to such amount of the income. Unlike the United States, the foreign tax credit limitation is determined on a per-country basis.

Proposed treaty limitations on internal law

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

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

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

In the case of Italy, the proposed treaty provides that the individual income tax (l'imposta sul reddito delle persone fisiche); the corporation income tax (l'imposta sul reddito delle persone giuridiche); and a portion of the regional tax on productive activities (l'imposta regionale sulle attivita produttive) (the so-called "IRAP" tax) are income taxes available for credit against U.S. tax liabilities.

The IRAP tax applies to Italian residents as well as nonresidents of Italy with a permanent establishment in Italy. The IRAP tax base is calculated without a deduction for labor costs and, for certain taxpayers, without a deduction for interest costs. With respect to manufacturing companies, for example, the IRAP tax base generally equals gross revenues from sales in Italy, with certain deductions for costs of goods sold, rent, and depreciation. No deduction is permitted for interest or labor expenses. With respect to banks and other financial institutions, the tax base generally equals interest and other income received, with certain deductions including interest paid, rent and depreciation (but with no deduction for labor expenses). The initial IRAP tax rate generally is 4.25 percent (5.4 percent for banks and other financial institutions). Because the IRAP tax base does not permit deductions for labor and, in certain cases, interest, it is not likely to be a creditable tax under U.S. internal law.

The proposed treaty provides that a portion of the taxes imposed under the IRAP will be considered to be a creditable income tax under this article. The proposed treaty provides a formula under which the creditable amount is calculated by multiplying the "applicable ratio" by the total amount of tax paid or accrued to Italy under the IRAP. The applicable ratio is a fraction, the numerator of which is the total IRAP tax base decreased (but not below zero) by labor expense and interest expense not otherwise taken into account in connection with the IRAP tax base. The denominator of the fraction is the actual tax base upon which Italy imposes the IRAP tax. The result of this calculation is an amount of the IRAP tax that approximates what the tax would have been had it been imposed on net income.

The proposed treaty generally provides that in taxing its residents Italy may include in its tax base income that the United States may tax under the proposed treaty, but that if Italy does so, it must credit U.S. taxes paid by the Italian resident on that income that is taxable in the United States. This credit is not to exceed the amount of the tax that would be paid to the United States if the resident were not a U.S. citizen. That is, in the case of an Italian resident who is subject to U.S. tax on worldwide income as a U.S. citizen, Italy will credit only the U.S. tax to which the Italian resident would have been subject absent U.S. citizenship. Italy need not credit U.S. taxes if the relevant item of income is subject in Italy to a final withholding tax by request of the recipient in accordance with Italian law.

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 Italian residents. Under this rule, Italy will allow a foreign tax credit to a U.S. citizen who is resident in Italy by taking into account only the amount of U.S. taxes paid pursuant to the proposed treaty (other than taxes that may be imposed solely by reason of citizenship under the saving clause of Article 1 (Personal Scope)) with respect to items of income that are either exempt from U.S. tax or are subject to a reduced rate of tax when derived by an Italian resident who is not a U.S. citizen. The United States will then credit the income tax actually paid to Italy, determined after application of the preceding sentence. The proposed treaty recharacterizes the income that is subject to Italian taxation as foreign source income for purposes of this computation, but only to the extent necessary to avoid double taxation of such income.

The proposed treaty provides a resourcing rule for purposes of the U.S. foreign tax credit in the case of a person who is a dual national of the United States and Italy, and is taxable by Italy on income for services rendered to the Italian government (under Article 19(1)(a)), but is taxable by the United States under the saving clause. In such cases, the proposed treaty provides that such income is treated as Italian-source income for purposes of the U.S. foreign tax credit. The Technical Explanation states that this resourcing rule is provided in order to relieve potential double taxation. Thus, the United States may tax such income but must allow a credit for the Italian income tax, if any, in accordance with the other provisions of this article.

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

Article 24. Non-Discrimination

The proposed treaty contains a comprehensive non-discrimination article relating to all taxes of every kind imposed at the national, state, or local level. It is similar to the non-discrimination article in the U.S. model, the present treaty, and to provisions that have been included in other recent U.S. income tax treaties.

In general, under the proposed treaty, one country cannot discriminate by imposing 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 rule applies (notwithstanding the personal scope article (Article 1)) whether or not the nationals in question are residents of the United States or Italy. However, for purposes of U.S. tax, U.S. citizens subject to tax on a worldwide basis are not in the same circumstances as Italian nationals who are not U.S. residents.

Under the proposed treaty, neither country may tax a permanent establishment of an enterprise of the other country less favorably than it taxes its own enterprises carrying on the same activities. Consistent with the U.S. model and the OECD model, however, 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 that are granted to its own residents.

Each country is required (subject to the arm's-length pricing rules of paragraph 1 of Article 9 (Associated Enterprises), paragraph 7 of Article 11 (Interest), and paragraph 7 of Article 12 (Royalties)) to allow its residents to deduct interest, royalties, and other disbursements paid by them to residents of the other country under the same conditions that it allows deductions for such amounts paid to residents of the same country as the payor. The Technical Explanation states that the term "other disbursements" is understood to include a reasonable allocation of executive and general administrative expenses, research and development expenses, and other expenses incurred for the benefit of a group of related persons. The Technical Explanation further states that the rules of section 163(j) of the Code are not discriminatory within the meaning of this provision.

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

Notwithstanding the definition of taxes covered in Article 2, this article applies to taxes of every kind and description imposed by either country, or a political subdivision or local authority thereof. The proposed protocol provides that nothing in the non-discrimination article is to be construed as preventing either of the countries from imposing a branch profits tax or a branch-level interest tax.

The saving clause (which allows the country of residence or citizenship to impose tax notwithstanding certain treaty provisions) does not apply to the non-discrimination article. Thus, a U.S. citizen resident in Italy 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, that authorizes the competent authorities of the two countries to consult together to attempt to alleviate individual cases of double taxation not in accordance with the proposed treaty. The saving clause of the proposed treaty does not apply to this article, so that the application of this article might result in a waiver (otherwise mandated by the proposed treaty) of taxing jurisdiction by the country of citizenship or residence.

Under this article, a resident of one country who considers that the action of one or both of the countries will cause him or her to be subject to tax which is not in accordance with the proposed treaty may (irrespective of internal law remedies) present his or her case to the competent authority of the country in which he or she is a resident, or if the case comes under the non-discrimination article (Article 24), to the competent authority of the country in which he or she is a national. Similar to the OECD model, and unlike the U.S. model, the proposed treaty provides that the case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the treaty. The competent authority will then make a determination as to whether the objection appears justified. If the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, that competent authority must endeavor to resolve the case by mutual agreement with the competent authority of the other country, with a view to the avoidance of taxation which is not in accordance with the proposed treaty. The provision authorizes a waiver of the statute of limitations of either country.

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. The competent authorities may also consult together for the elimination of double taxation regarding cases not provided for in the proposed treaty. This treatment is similar to the treatment under the U.S. model. The proposed protocol makes clear that the competent authorities can agree that the conditions for application of the main purpose provisions in Articles 10 (Dividends), 11 (Interest), 12 (Royalties), or 22 (Other Income) have been met.

The proposed treaty authorizes the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of this mutual agreement article. The Technical Explanation states that this provision makes clear that it is not necessary to go through diplomatic channels in order to discuss problems arising in the application of the proposed treaty. When it seems advisable in order to reach agreement to have an oral exchange of opinions, such exchange may take place through a Commission consisting of representatives of both country's competent authorities.

Under the proposed treaty, if an agreement cannot be reached by the competent authorities pursuant to the rules described above, the case may, if agreed to by the taxpayer and each competent authority, be submitted to arbitration. The arbitration procedure does not become effective at the same time as the remainder of the treaty; instead, the arbitration procedure becomes effective on the date specified in a future exchange of diplomatic notes. The proposed protocol provides that within three years after entry into force of the proposed treaty, the competent authorities will consult to determine whether it is appropriate to exchange diplomatic notes implementing the arbitration procedure. The Memorandum of Understanding elaborates on the circumstances under which an exchange of diplomatic notes implementing the arbitration procedure will take place and also sets forth the procedures that will apply to arbitration proceedings if the provision is implemented.

If the arbitration procedures become effective, the following rules apply. The taxpayer must agree in writing to be bound by the decision of the arbitration board. The competent authorities are permitted to release to the arbitration board such information as is necessary for carrying out the arbitration procedure. Any award of the arbitration board is binding on the taxpayer as well as each treaty country, with respect to the case at hand.

Article 26. Exchange of Information

This article provides for the exchange of information between the two countries. Notwithstanding the provisions of Article 2 (Taxes Covered), the proposed protocol provides that the information exchange provisions apply to all taxes imposed in either country at the national level.

The proposed treaty provides that the two competent authorities will exchange such information as is necessary to carry out the provisions of the proposed treaty, or the provisions of the domestic laws of the two countries concerning taxes to which the proposed treaty applies (provided that the taxation under those domestic laws is not contrary to the proposed treaty), and for the prevention of fraud and tax evasion. This exchange of information is not restricted by Article 1 (Personal Scope). Therefore, information with respect to third-country residents is covered by these procedures.

Any information exchanged under the proposed treaty is treated as secret in the same manner as information obtained under the domestic laws of the country receiving the information. The exchanged information may be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes to which the proposed treaty applies. Such persons or authorities must use the information for such purposes only.[9] The proposed protocol provides that information may also be disclosed to persons or authorities involved in the oversight of such activities. The Technical Explanation states that persons involved in the oversight of taxes include legislative bodies with oversight roles with respect to the administration of the tax laws, such as, for example, the tax-writing committees of Congress and the General Accounting Office. Information received by these bodies must be for use in the performance of their role in overseeing the administration of U.S. tax laws. Exchanged information may be disclosed in public court proceedings or in judicial decisions.

As is true under the U.S. model and the OECD model, under the proposed treaty, a country is not required to carry out administrative measures at variance with the laws and administrative practice of either country, to supply information that is not obtainable under the laws or in the normal course of the administration of either country, or to supply information that would disclose any trade, business, industrial, commercial, or professional secret or trade process or information, the disclosure of which would be contrary to public policy.

[9] 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 the proposed treaty could not be used for these nontax purposes.

Under the proposed protocol, a country may collect on behalf of the other country such amounts as may be necessary to ensure that relief granted under the treaty by the other country does not enure to the benefit of persons not entitled thereto. However, neither country is obligated, in the process of providing collection assistance, to carry out administrative measures that differ from those used in the collection of its own taxes, or that would be contrary to its sovereignty, security, or public policy.

Article 27. Diplomatic Agents and Consular Officials

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

Article 28. Entry into Force

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

With respect to 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 the date on which the proposed treaty enters into force. With respect to other taxes, the proposed treaty will be effective for taxable periods beginning on or after the first day of January next following the date on which the proposed treaty enters into force.

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 29. Termination

The proposed treaty will continue in force until terminated by either country. Either country may terminate the proposed treaty at any time after five years from the date of entry into force, provided that at least six months prior notice of termination is given through diplomatic channels. With respect to taxes withheld at source, a termination is effective for amounts paid or credited on or after the first day of January next following the expiration of the six-month period of notification. With respect to other taxes, a termination is effective for taxable periods beginning on or after the first day of January next following the expiration of the six-month notification period.

IX. Explanation of Proposed Protocol

A detailed, article-by-article explanation of the proposed protocol, is set forth below. Certain provisions of the proposed protocol have been described in Part VIII. above in connection with the description of the proposed treaty.

Article 1

Article 1 of the proposed protocol modifies specific articles of the proposed treaty. Discussions of such modifications appear in the discussions of the affected articles, above.

Article 2

The proposed protocol contains a provision generally intended to limit the indirect use of the proposed treaty by persons who are not entitled to its benefits by reason of residence in the United States or Italy. The present treaty contains a provision that is not as extensive.

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

The proposed anti-treaty shopping article provides that a resident of either Italy or the United States will be entitled to the benefits of the proposed treaty only if the resident:

(1) is an individual;
(2) is a qualified governmental entity;
(3) is a company that satisfies a public company test;
(4) is a company that is owned by certain public companies;
(5) is a charitable organization or other legal person established and maintained exclusively for a religious, charitable, educational, scientific, or other similar purpose;
(6) is a pension fund that satisfies an ownership test; or
(7) is an entity that satisfies both an ownership and base erosion test.

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

Individuals

An individual resident of a treaty country is entitled to the benefits of the proposed treaty.

Qualified governmental entities

Under the proposed protocol, a qualified governmental entity is entitled to all treaty benefits. Qualified governmental entities include the two countries, their political or administrative subdivisions, or their local authorities. Qualified governmental entities also include certain wholly-owned entities, the earnings of which are credited to the entity's own account, and certain pension trusts or funds providing government service pension benefits.

Public company tests

A company that is a resident of Italy or the United States is entitled to treaty benefits if more than 50 percent of the vote and value of all classes of the shares in such company are regularly traded on a recognized stock exchange. In addition, a company is entitled to treaty benefits if at least 50 percent of each class of shares of the company is owned (directly or indirectly) by five or fewer companies that satisfy the test previously described, provided that each intermediate owner used to satisfy the control requirement is a resident of Italy or the United States. These rules follow the corresponding rules in the U.S. model.

Under the proposed protocol, the term "recognized stock exchange" means (1) the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934; (2) any stock exchange constituted and organized according to Italian laws; and (3) any other stock exchange agreed upon by the competent authorities of both countries.

Tax exempt organizations

An entity is entitled to the benefits under the proposed treaty if it is a legal person organized under the laws of a treaty country, generally exempt from tax in such country, and that is established and maintained in such country exclusively for a religious, charitable, educational, scientific, or other similar purpose.

Pension funds

A legal person, whether or not exempt from tax, is entitled to treaty benefits if (1) it is organized under the laws of a treaty country to provide pension or other similar benefits to employees pursuant to a plan, and (2) more than 50 percent of the person's beneficiaries, members, or participants are individuals resident in either treaty country. This rule is similar to the rule in the U.S. model.

Ownership and base erosion tests

Under the proposed protocol, an entity that is a resident of one of the countries is entitled to treaty benefits if it satisfies an ownership test and a base erosion test. Under the ownership test, on at least half of the days during the taxable year at least 50 percent of each class of the beneficial interests in an entity must be owned (directly or indirectly) by certain qualified residents described above (i.e., an individual; a qualified governmental entity; a company that satisfies one of the public company tests (described in the discussion of public company tests above); a charitable organization or other legal person established and maintained exclusively for a religious, charitable, educational, scientific, or other similar purpose; or a legal person that satisfies the test for pension funds (described in the discussion of pension funds above)). The Technical Explanation states that trusts may be entitled to treaty benefits if they are treated as residents of a treaty country and otherwise satisfy the requirements under these provisions.

The base erosion test is satisfied only if less than 50 percent of the person's gross income for the taxable year is paid or accrued (directly or indirectly), in the form of deductible payments, to persons who are not residents of either treaty country (unless the payment is attributable to a permanent establishment situated in either treaty country). This rule is intended to prevent a corporation, for example, from distributing most of its income, in the form of deductible items such as interest, royalties, service fees, or other amounts to persons not entitled to benefits under the proposed treaty. This treatment is similar to the corresponding rule in the U.S. model. The term "gross income" is not defined in the proposed treaty or proposed protocol and therefore will be defined according to the respective country's laws that is applying the treaty. The Technical Explanation states that for purposes of the base erosion test, in the case of the United States, "gross income" is defined as gross receipts less cost of goods sold.

Active business test

A resident satisfies the active business test if it is engaged in the active conduct of a trade or business in its country of residence; the income is connected with or incidental to that trade or business; and the trade or business is substantial in relation to the activity in the other country generating the income. However, the proposed protocol provides that the business of making or managing investments does not constitute an active trade or business (and benefits therefore may be denied) unless such activity is a banking, insurance, or securities activity conducted by a bank, insurance company, or registered securities dealer.

The proposed protocol provides that the determination of whether a trade or business is substantial is made based on all facts and circumstances. However, the proposed protocol provides a safe harbor rule under which a trade or business of the resident is considered to be substantial if certain attributes of the residence-country business exceed a threshold fraction of the corresponding attributes of the trade or business located in the source country that produces the source-country income. Under this safe harbor, the attributes are assets, gross income, and payroll expense. To satisfy the safe harbor, the level of each such attribute in the active conduct of the trade or business by the resident (and any related parties) in the residence country, and the level of each such attribute in the trade or business producing the income in the source country, is measured for the prior year or for the prior three years. For each separate attribute, the ratio of the residence country level to the source country level is computed.

In general, the safe harbor is satisfied if, for the prior year or for the average of the three prior years, the average of the three ratios exceeds 10 percent, and each ratio separately is at least 7.5 percent. These rules are similar to those contained in the U.S. model. In determining these ratios, only amounts to the extent of the resident's direct or indirect ownership interest in the activity in the other treaty country are taken into account. The Technical Explanation provides that if neither the resident nor any of its associated enterprises has an ownership interest in the activity in the other country, the resident's trade or business in its country of residence is considered substantial in relation to such activity.

The proposed protocol provides that income is derived in connection with a trade or business if the activity in the other country generating the income is a line of business that forms a part of or is complementary to the trade or business. The Technical Explanation states that a business activity generally is considered to "form a part of" a business activity conducted in the other country if the two activities involve the design, manufacture, or sale of the same products or type of products, or the provision of similar services. The Technical Explanation further provides that in order for two activities to be considered to be "complementary," the activities need not relate to the same types of products or services, but they should be part of the same overall industry and be related in the sense that the success or failure of one activity will tend to result in success or failure for the other. Under the proposed protocol, income is incidental to a trade or business if it facilitates the conduct of the trade or business in the other country.

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

Grant of treaty benefits by the competent authority

The proposed protocol provides a "safety-valve" for a person that has not established that it meets one of the other more objective tests, but for which the allowance of treaty benefits would not give rise to abuse or otherwise be contrary to the purposes of the treaty. Under this provision, such a person may be granted treaty benefits if the competent authority of the source country so determines. The corresponding article in the U.S. model contains a similar rule. The Technical Explanation states that for this purpose, factors the competent authorities are to take into account are whether the establishment, acquisition, and maintenance of the person, and the conduct of its operations, did not have as one of its principal purposes the obtaining of treaty benefits.

Article 3

This article of the proposed protocol contains the standard rule that the proposed treaty will 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 Italy. Thus, the proposed treaty will not apply to increase the tax burden of a resident of either the United States or Italy.

This article also provides that the dispute resolution procedures under the mutual agreement article take precedence over the corresponding provisions of any other agreement to which the United States and Italy are parties in determining whether a measure is within the scope of the proposed treaty. It also provides that, unless the competent authorities agree that a taxation measure is outside the scope of the proposed treaty, only the proposed treaty's non-discrimination rules, and not the non-discrimination rules of any other agreement in effect between the United States and Italy, generally apply to that 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 similar provision or action.

Article 4

This article provides that a U.S. citizen and Italian resident who is a partner in a U.S. partnership is entitled to a refundable credit against his or her Italian individual income tax (l'imposta sul reddito delle persone fisiche) for the taxable period that equals the portion of his Italian corporate tax (l'imposta sul reddito delle persone giuridiche) that is attributable to his or her share of the partnership income. In other words, Italy agrees to treat a U.S. partnership in the way that the United States treats it, as a flowthrough entity for tax purposes, when the partner whose tax is at issue is a U.S. citizen who is an Italian resident.

Article 5

This article provides for one method by which the competent authority of one of the two countries may allow the reduced withholding tax rates of the proposed treaty. The article establishes rules that will apply if either country establishes a refund system for withholding taxes whose rates the treaty reduces. In the case of such a refund system, the source country will withhold taxes at the regular rate, without regard to treaty reduction of that rate. Thereupon, the taxpayer receiving the income is to make to the source country a claim for refund (within the time fixed by law of the source country for claiming a refund) and to furnish with the claim an official certificate of his residence country that certifies the existence of the conditions allowing the reduced treaty rate to that taxpayer. The proposed treaty does not obligate the United States or Italy to establish a refund system. The United States does not presently use such a system, but rather, allows a payor to reduce withholding taxes at the source based on residence documentation provided by the beneficial owner of a U.S.-source payment.

Article 6

This article provides that each country may collect taxes for the other country to the extent necessary to insure that benefits of the treaty are not going to persons not entitled to those benefits. This treaty obligation does not oblige either country to use administrative measures that it does not use in collecting its own taxes or that are contrary to its sovereignty, security, or public policy.

Article 7

This article contains two provisions. The first states that either country may request consultations with the other country to determine whether amendment to the proposed treaty is appropriate to respond to changes in the law or policy of either country. If these consultations determine that the effect of the proposed treaty or its application have been changed by domestic legislation of either country resulting in an alteration to the balance of benefits provided by the proposed treaty, further consultations shall occur with a view toward amending the proposed treaty to restore an appropriate balance of benefits.

The second provision in this article relates to the implementation of the mutual agreement procedures of the proposed treaty. This provision states that within three years of the entry into force of the proposed treaty, the competent authorities shall consult with respect to the implementation of the mutual agreement procedures. They shall take into account experience with respect to the mutual agreement procedures and shall determine whether modifications to that article of the proposed treaty would be appropriate. In addition, after taking into account experience with respect to arbitration of international tax disputes, they shall also determine whether it is appropriate to exchange the diplomatic notes that are prerequisite to the commencement of the arbitration procedures of the proposed treaty.

The Memorandum of Understanding provides further detail regarding the arbitration proceedings. First, it states that the requisite diplomatic notes will be exchanged when the experience of the two countries with respect to similar provisions in other specified treaties has proven to be satisfactory. Second, if this condition is satisfied and the arbitration procedures become operative, the Memorandum of Understanding specifies that the results of the arbitration are to be binding. Third, it provides procedural rules for the arbitration, such as specifying time limits, appointment procedures for arbitrators, and rules for costs.

Article 8

Under this article of the proposed protocol, if a U.S. state or local government imposes tax on the profits of Italian enterprises from the operation of ships or aircraft in international traffic, Italy may impose its regional tax on productive activities (l'imposta regionale sulle attivita produttive) on the profits of U.S. enterprises from such activities, notwithstanding the provisions of Article 2 (Taxes

Covered) and Article 8 (Shipping and Air Transport) of the proposed treaty.

X. 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 Government of the United States of America and the Government of the Italian Republic for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fraud or Fiscal Evasion, signed at Washington on August 25, 1999, together with a Protocol (Treaty Doc. 106–11), subject to the reservation of subsection (a), the understanding of subsection (b), the declaration of subsection (c), and the proviso of subsection (d).

(a) RESERVATION.—The Senate's advice and consent is subject to the following reservation, which shall be included in the instrument of ratification, and shall be binding on the President:

(1) MAIN PURPOSE TESTS.—Paragraph 10 of Article 10 (Dividends), paragraph 9 of Article 11 (Interest), paragraph 8 of Article 12 (Royalties), and paragraph 3 of Article 22 (Other Income) of the Convention, and paragraph 19 of Article 1 of the Protocol (dealing with Article 25 (Mutual Agreement Procedure) of the Convention) shall be stricken in their entirety, and paragraph 20 of Article 1 of the Protocol shall be renumbered as paragraph 19.

(b) UNDERSTANDING.—The Senate's advice and consent is subject to the following understanding, which shall be included in the instrument of ratification, and shall be binding on the President:

(1) EXCHANGE OF INFORMATION.—The United States understands that, pursuant to Article 26 of the Convention, both the competent authority of the United States and the competent authority of the Republic of Italy have the authority to obtain and provide information held by financial institutions, nominees or persons acting in an agency or fiduciary capacity, or respecting interests in a person.

(c) DECLARATION.—The Senate's advice and consent is subject to the following declaration, which shall be binding on the President:

(1) 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.

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

(1) SUPREMACY OF CONSTITUTION.—Nothing in the Convention 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.

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