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TAX CONVENTION WITH MALTA

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

REPORT

[To accompany Treaty Doc. 111-1]

The Committee on Foreign Relations, to which was referred the Convention between the Government of the United States of America and the Government of Malta with respect to Taxes on Income, signed on August 8, 2008, at Valletta (the “Convention”) (Treaty Doc. 111-1), having considered the same, reports favorably thereon with one declaration, as indicated in the resolution of advice and consent, and recommends that the Senate give its advice and consent to ratification thereof, as set forth in this report and the accompanying resolution of advice and consent.

CONTENTS

	Page
I. Purpose .....	1
II. Background .....	2
III. Major Provisions .....	2
IV. Entry Into Force .....	4
V. Implementing Legislation .....	4
VI. Committee Action .....	4
VII. Committee Recommendation and Comments .....	5
VIII. Text of Resolution of Advice and Consent to Ratification .....	6
IX. Annex I—Technical Explanation .....	7
X. Annex II—Transcript of Hearing Held November 10, 2009 .....	97

I. PURPOSE

The purpose of the new Malta Convention is to promote and facilitate trade and investment between the United States and Malta. Principally, the Convention provides for reduced withholding rates on cross-border payments of dividends, interest, royalties, and other income, as well as the elimination of withholding taxes on cross-border dividend payments to pension funds. The Convention contains rigorous protections designed to protect against “treaty shopping,” which is the inappropriate use of a tax treaty by third-country residents, and provisions to ensure the ex-

change of information between tax authorities in both countries. While the proposed Convention generally follows the 2006 U.S. Model Income Tax Treaty (the “U.S. Model”), it deviates from the U.S. Model in certain respects, including by providing enhanced protections against treaty shopping.

## II. BACKGROUND

There is no income tax treaty currently in force between the United States and Malta. The previous U.S.-Malta tax treaty (signed on March 21, 1980) was terminated by the United States on January 1, 1997, due to concerns that changes to Maltese tax law provided an incentive for “treaty shopping” and that Malta was unable to satisfactorily exchange tax information. After Malta changed its tax law in an effort to address these concerns, the United States negotiated and concluded the Convention. While the changes to Malta’s tax law were critical to the Treasury Department’s willingness to re-engage Malta in a double taxation treaty, it was nonetheless deemed necessary to include protections against “treaty shopping” that go beyond those in the U.S. model. The Convention was signed on August 8, 2008.

## III. MAJOR PROVISIONS

A detailed article-by-article analysis of the Convention may be found in the Technical Explanation Published by the Department of the Treasury on November 10, 2009. In addition, the staff of the Joint Committee on Taxation prepared an analysis of the Convention, JCX-50-09 (November 6, 2009), which was of great assistance to the committee in reviewing the Convention. A summary of the key provisions of the Convention is set forth below.

### *General Scope*

Article 1 provides that the scope of the Convention would generally apply only to “residents” of the United States and Malta. It contains a standard “saving clause” pursuant to which each country retains the right to tax its residents and citizens as if the Treaty had not come into effect. This article also contains a standard provision providing in general that the Convention may not be applied to deny a taxpayer any benefits to which the taxpayer would be entitled under the domestic law of a country or under any other agreement between the two countries.

### *Covered taxes*

Pursuant to Article 2, the Convention would apply to all taxes on income, including gains-irrespective of the manner in which they are levied. Except with respect to the benefits provided by Article 24 (Non-Discrimination), state and local taxes, including property taxes, do not fall within the scope of the proposed treaty.

### *Dividends*

Articles 10 and 13 provide that dividends and certain gains derived by a resident of either country from sources within the other country (residence-country taxation) may be taxed by both countries. However, the proposed treaty limits the rate of taxation that the source country may impose on certain dividends paid to a resi-

dent of the other country. The withholding tax rates on dividends are generally consistent with those contained in the U.S. Model Treaty, but they represent a departure from the exemption from source-country withholding tax provided by several recent U.S. treaties and protocols thereto for dividends paid by subsidiaries to parent corporations resident in the other treaty countries.

#### *Interest and Royalties*

Article 11 limits the rate of source-country tax that may be imposed on interest arising in one treaty country (the source country) and beneficially owned by a resident of the other country so that it may not exceed 10 percent of the gross amount of the interest. *See* Article 11(2). Similarly, Article 12 provides that a royalty payment arising in a treaty country and beneficially owned by a resident of the other treaty country may be subject to a source country tax of up to 10 percent of the gross amount of the royalty. *See* Article 12(2). These provisions differ from the corresponding rules of the U.S. Model Treaty, which provides an exemption from source-country taxation for most interest and royalty payments beneficially owned by a resident of the other country. Although the U.S. Model Treaty eliminates source-country withholding tax on most payments of interest, royalties or other income, exemption from withholding tax was deemed not appropriate in this case, in light of Malta's unique tax system. The Convention therefore provides for withholding at a rate of 10 percent on interest, royalties, and other income.

#### *Pensions and Similar Remuneration*

Under Articles 17 and 18, pensions and similar remuneration paid to a resident of one country may be taxed only by that country and only at the time and to the extent that a pension distribution is made. These articles are exceptions to the rule permitting the residence country to tax cross-border pensions. Under these provisions, the residence country may not tax any amount of such a pension or similar remuneration that would be exempt from taxation in the other country if the beneficial owner was a resident of that other country. The other remuneration covered by these articles includes social security benefits, annuities, alimony, child support (Article 17) and pension funds (Article 18). As noted previously, the Convention would generally eliminate withholding tax on cross-border dividend payments to pension funds. The Convention's treatment of pensions differs from the U.S. Model Treaty in some respects. Like the U.S. Model Treaty, the Convention provides that pension distributions (or similar remuneration) owned by a resident of a contracting country are only taxable in the recipient's country of residence. *See* Article 17. In addition, a pension beneficiary's country of residence must exempt from taxation a pension amount that would be exempt from tax in the other country where the pension fund is established. However, the Convention differs from the U.S. Model Treaty in that it does not contain certain provisions that deal with the tax treatment of cross-border pension contributions. These provisions typically cover, among other things, the tax treatment of pension contributions (paid by an individual or an individual's employer) when an individual is a participant or

beneficiary of a pension fund resident in one country, but employed in another country.

*Limitation on Benefits*

Consistent with current U.S. treaty policy, Article 22 includes a “Limitation on Benefits” provision, which is designed to avoid treaty-shopping by limiting the indirect use of a treaty’s benefits by persons who were not intended to take advantage of those benefits. The limitation on benefits provision states that in situations in which the country of source retains the right under the Convention to tax income derived by residents of the other country, the Convention provides for relief from the potential double taxation through allowance by the country of residence of a tax credit for certain foreign taxes paid to the other country. This article’s limitation on benefits provision generally reflects the anti-treaty-shopping provisions included in the U.S. Model Treaty and more recent U.S. income tax treaties, but it is more stringent in a number of respects to ensure that third-country residents do not inappropriately benefit from the Convention.

*Exchange of Information*

The Convention provides that the United States and Malta shall exchange certain tax information. Under Article 26, the United States is allowed to obtain such information from Malta regardless of whether Malta needs the information for its own tax purposes. Changes to Maltese tax law since the previous treaty was terminated, including at the request of the United States during the negotiating process, will facilitate the exchange of tax information and made it possible for Malta to agree to comprehensive information exchange obligations in the Convention. The exchange of information provision set out in Article 26 is substantially similar to the provision found in the U.S. Model Treaty.

IV. ENTRY INTO FORCE

The Convention will enter into force on the date of the exchange of instruments of ratification, yet certain provisions will not have effect immediately. *See* Article 28.

V. IMPLEMENTING LEGISLATION

As is the case generally with income tax treaties, the Convention is self-executing and does not require implementing legislation for the United States.

VI. COMMITTEE ACTION

The committee held a public hearing on the Convention on November 10, 2009. Testimony was received from Manal Corwin, International Tax Counsel, U.S. Department of Treasury, and Thomas A. Barthold, Chief of Staff, Joint Committee on Taxation. The transcript of this hearing can be found in Annex II.

On April 13, 2010, the committee considered the Convention and ordered it favorably reported by voice vote, with a quorum present and without objection.

## VII. COMMITTEE COMMENTS

The Committee on Foreign Relations believes that the Convention will stimulate increased trade and investment, reduce treaty-shopping incentives, and promote closer co-operation between the United States and Malta. The committee therefore urges the Senate to act promptly to give advice and consent to ratification of the Convention, as set forth in this report and the accompanying resolution of advice and consent.

## A. LIMITATION ON BENEFITS

As noted above, the previous U.S.-Malta tax treaty was terminated by the United States on January 1, 1997, in large part due to provisions of Maltese domestic law that created strong incentives for treaty-shopping. Such abuses may undermine the integrity of a bilateral tax relationship, and the committee applauds the Treasury Department's significant efforts to address treaty shopping both in this Convention and in other bilateral tax treaties.

After careful examination of this Convention, as well as testimony and responses to questions for the record from the Treasury Department, the committee is of the view that the Convention's protections against treaty-shopping are robust and will substantially deny treaty shoppers the benefit of the Convention. The limitation on benefits provision, Article 22, is more restrictive than that in the 2006 U.S. Model tax treaty or in any existing U.S. tax treaty. In conjunction with this extensive limitation on benefits provision, the Convention contains relatively high rates for source country taxation of dividends, interest, and royalties, which will make the Convention less attractive to treaty shoppers. These issues are addressed in more detail in the Treasury Department's responses to questions for the record, which are included in the hearing record appended to this report beginning at page 131. The committee believes that it is critical for the Treasury Department to closely monitor and keep the committee informed on the effectiveness of the above-mentioned provisions in discouraging and eliminating treaty-shopping under the Convention.

B. DECLARATION ON THE SELF-EXECUTING NATURE  
OF THE CONVENTION

The committee has included one declaration in the recommended resolution of advice and consent. The declaration states that the Convention is self-executing, as is the case generally with income tax treaties. Prior to the 110th Congress, the committee generally included such statements in the committee's report, but in light of the Supreme Court decision in *Medellin v. Texas*, 128 S. Ct. 1346 (2008), the committee determined that a clear statement in the Resolution is warranted. A further discussion of the committee's views on this matter can be found in Section VIII of Executive Report 110-12.

VIII. TEXT OF RESOLUTION OF ADVICE AND CONSENT TO  
RATIFICATION

*Resolved (two-thirds of the Senators present concurring therein),*

**SECTION 1. SENATE ADVICE AND CONSENT SUBJECT TO A DECLARATION**

The Senate advises and consents to the ratification of the Convention Between the Government of the United States of America and the Government of Malta for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed on August 8, 2008, at Valletta (the “Convention”) (Treaty Doc. 111–1), subject to the declaration of section 2.

**SECTION 2. DECLARATION**

The advice and consent of the Senate under section 1 is subject to the following declaration:

The Convention is self-executing.

## IX. ANNEX I—TECHNICAL EXPLANATION

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DEPARTMENT OF THE TREASURY TECHNICAL EXPLANATION OF THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF MALTA FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME SIGNED AT VALLETTA ON AUGUST 8, 2008

This is a technical explanation of the Convention between the Government of the United States and the Government of Malta For the Avoidance Of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed on August 8, 2008 (the “Convention”).

Negotiations took into account the U.S. Treasury Department’s current tax treaty policy, and the Treasury Department’s Model Income Tax Convention. Negotiations also took into account the Model Tax Convention on Income and on Capital, published by the Organisation for Economic Cooperation and Development (the “OECD Model”), and recent tax treaties concluded by both countries.

The Technical Explanation is an official guide to the Convention. It reflects the policies behind particular Convention provisions, as well as understandings reached during the negotiations with respect to the application and interpretation of the Convention. References in the Technical Explanation to “he” or “his” should be read to mean “he or she” or “his and her.”

### ARTICLE 1 (GENERAL SCOPE)

#### *Paragraph 1*

Paragraph 1 of Article 1 provides that the Convention applies only to residents of the United States or Malta except where the terms of the Convention provide otherwise. Under Article 4 (Resident) a person is generally treated as a resident of a Contracting State if that person is, under the laws of that State, liable to tax therein by reason of his domicile, citizenship, residence, or other similar criteria. However, if a person is considered a resident of both Contracting States, Article 4 provides rules for determining a State of residence (or no State of residence). This determination governs for all purposes of the Convention.

Certain provisions are applicable to persons who may not be residents of either Contracting State. For example, paragraph 1 of Article 24 (Non-Discrimination) applies to nationals of the Contracting States. Under Article 26 (Exchange of Information and Administrative Assistance), information may be exchanged with respect to residents of third states.

*Paragraph 2*

Paragraph 2 states the generally accepted relationship both between the Convention and domestic law and between the Convention and other agreements between the Contracting States. That is, no provision in the Convention may restrict any exclusion, exemption, deduction, credit or other benefit accorded by the tax laws of the Contracting States, or by any other agreement between the Contracting States. The relationship between the non-discrimination provisions of the Convention and the General Agreement on Trade in Services (the "GATS") is addressed in paragraph 3.

Under paragraph 2, for example, if a deduction would be allowed under the U.S. Internal Revenue Code (the "Code") in computing the U.S. taxable income of a resident of Malta, the deduction also is allowed to that person in computing taxable income under the Convention. Paragraph 2 also means that the Convention may not increase the tax burden on a resident of a Contracting States beyond the burden determined under domestic law. Thus, a right to tax given by the Convention cannot be exercised unless that right also exists under internal law.

It follows that, under the principle of paragraph 2, a taxpayer's U.S. tax liability need not be determined under the Convention if the Code would produce a more favorable result. A taxpayer may not, however, choose among the provisions of the Code and the Convention in an inconsistent manner in order to minimize tax. Thus, a taxpayer may use the Convention to reduce its taxable income, but may not use both treaty and Code rules where doing so would thwart the intent of either set of rules. For example, assume that a resident of Malta has three separate businesses in the United States. One is a profitable permanent establishment and the other two are trades or businesses that would earn taxable income under the Code but that do not meet the permanent establishment threshold tests of the Convention. One is profitable and the other incurs a loss. Under the Convention, the income of the permanent establishment is taxable in the United States, and both the profit and loss of the other two businesses are ignored. Under the Code, all three would be subject to tax, but the loss would offset the profits of the two profitable ventures. The taxpayer may not invoke the Convention to exclude the profits of the profitable trade or business and invoke the Code to claim the loss of the loss trade or business against the profit of the permanent establishment. (See Rev. Rul. 84-17, 1984-1 C.B. 308.) If, however, the taxpayer invokes the Code for the taxation of all three ventures, he would not be precluded from invoking the Convention with respect, for example, to any dividend income he may receive from the United States that is not effectively connected with any of his business activities in the United States.

Similarly, nothing in the Convention can be used to deny any benefit granted by any other agreement between the United States and Malta. For example, if certain benefits are provided for military personnel or military contractors under a Status of Forces Agreement between the United States and Malta, those benefits or protections will be available to residents of the Contracting States regardless of any provisions to the contrary (or silence) in the Convention.



*Paragraph 3*

Paragraph 3 specifically relates to non-discrimination obligations of the Contracting States under the GATS. The provisions of paragraph 3 are an exception to the rule provided in paragraph 2 of this Article under which the Convention shall not restrict in any manner any benefit now or hereafter accorded by any other agreement between the Contracting States.

Subparagraph (a) of paragraph 3 provides that, unless the competent authorities determine that a taxation measure is not within the scope of the Convention, the national treatment obligations of the GATS shall not apply with respect to that measure. Further, any question arising as to the interpretation of the Convention, including in particular whether a measure is within the scope of the Convention shall be considered only by the competent authorities of the Contracting States, and the procedures under the Convention exclusively shall apply to the dispute. Thus, paragraph 3 of Article XXII (Consultation) of the GATS may not be used to bring a dispute before the World Trade Organization unless the competent authorities of both Contracting States have determined that the relevant taxation measure is not within the scope of Article 24 (Non-Discrimination) of the Convention.

The term “measure” for these purposes is defined broadly in subparagraph (b) of paragraph 3. It would include, for example, a law, regulation, rule, procedure, decision, administrative action or guidance, or any other form of measure.

*Paragraph 4*

Paragraph 4 contains the traditional saving clause found in all U.S. treaties. The Contracting States reserve their rights, except as provided in paragraph 5, to tax their residents and citizens as provided in their internal laws, notwithstanding any provisions of the Convention to the contrary. For example, if a resident of Malta performs professional services in the United States and the income from the services is not attributable to a permanent establishment in the United States, Article 7 (Business Profits) would by its terms prevent the United States from taxing the income. If, however, the resident of Malta is also a citizen of the United States, the saving clause permits the United States to include the remuneration in the worldwide income of the citizen and subject it to tax under the normal Code rules (i.e., without regard to Code section 894(a)). However, subparagraph 5(a) of Article 1 preserves the benefits of special foreign tax credit rules applicable to the U.S. taxation of certain U.S. income of its citizens resident in Malta. See paragraph 4 of Article 23 (Relief from Double Taxation).

For purposes of the saving clause, “residence” is determined under Article 4 (Resident). Thus, an individual who is a resident of the United States under the Code (but not a U.S. citizen) but who is determined to be a resident of the other Contracting State under the tie-breaker rules of Article 4 would be subject to U.S. tax only to the extent permitted by the Convention. The United States would not be permitted to apply its statutory rules to that person to the extent the rules are inconsistent with the treaty.

However, the person would be treated as a U.S. resident for U.S. tax purposes other than determining the individual’s U.S. tax li-

ability. For example, in determining under Code section 957 whether a foreign corporation is a controlled foreign corporation, shares in that corporation held by the individual would be considered to be held by a U.S. resident. As a result, other U.S. citizens or residents might be deemed to be United States shareholders of a controlled foreign corporation subject to current inclusion of Subpart F income recognized by the corporation. See, *Treas. Reg. section 301.7701(b)-7(a)(3)*.

Under paragraph 4, each Contracting State also reserves its right to tax former citizens and former long-term residents for a period of ten years following the loss of such status. Thus, paragraph 4 allows the United States to tax former U.S. citizens and former U.S. long-term residents in accordance with Section 877 of the Code. Section 877 generally applies to a former citizen or long-term resident of the United States who relinquishes citizenship or terminates long-term residency before June 17, 2008 if he fails to certify that he has complied with U.S. tax laws during the 5 preceding years, or if either of the following criteria exceed established thresholds: (a) the average annual net income tax of such individual for the period of 5 taxable years ending before the date of the loss of status, or (b) the net worth of such individual as of the date of the loss of status.

The United States defines “long-term resident” as an individual (other than a U.S. citizen) who is a lawful permanent resident of the United States in at least 8 of the prior 15 taxable years. An individual is not treated as a lawful permanent resident for any taxable year in which the individual is treated as a resident of Malta under this Convention, or as a resident of any country other than the United States under the provisions of any other U.S. tax treaty, and the individual does not waive the benefits of the relevant tax treaty.

#### *Paragraph 5*

Paragraph 5 sets forth certain exceptions to the saving clause. The referenced provisions are intended to provide benefits to citizens and residents even if such benefits do not exist under internal law. Paragraph 5 thus preserves these benefits for citizens and residents of the Contracting States.

Subparagraph (a) lists certain provisions of the Convention that are applicable to all citizens and residents of a Contracting State, despite the general saving clause rule of paragraph 4:

(1) Paragraph 2 of Article 9 (Associated Enterprises) grants the right to a correlative adjustment with respect to income tax due on profits reallocated under Article 9.

(2) Paragraphs 1(b), 2, and 5 of Article 17 (Pensions, Social Security, Annuities, Alimony and Child Support) provide exemptions from source or residence State taxation for certain pension distributions, social security payments and child support.

(3) Article 18 (Pensions Funds) provides an exemption for certain investment income of pension funds located in the other Contracting State.

(4) Article 23 (Relief from Double Taxation) confirms to citizens and residents of one Contracting State the benefit of a

credit for income taxes paid to the other or an exemption for income earned in the other State.

(5) Article 24 (Non-Discrimination) protects residents and nationals of one Contracting State against the adoption of certain discriminatory taxation practices in the other Contracting State.

(6) Article 25 (Mutual Agreement Procedure) confers certain benefits on citizens and residents of the Contracting States in order to reach and implement solutions to disputes between the two Contracting States. For example, the competent authorities are permitted to use a definition of a term that differs from an internal law definition. The statute of limitations may be waived for refunds, so that the benefits of an agreement may be implemented.

Subparagraph (b) of paragraph 5 provides a different set of exceptions to the saving clause. The benefits referred to are all intended to be granted to temporary residents of a Contracting State (for example, in the case of the United States, holders of non-immigrant visas), but not to citizens or to persons who have acquired permanent residence in that State. If beneficiaries of these provisions travel from one of the Contracting States to the other, and remain in the other long enough to become residents under its internal law, but do not acquire permanent residence status (i.e., in the U.S. context, they do not become “green card” holders) and are not citizens of that State, the host State will continue to grant these benefits even if they conflict with the statutory rules. The benefits preserved by this paragraph are the host country exemptions for government service salaries and pensions under Article 19 (Government Service), certain income of visiting students and trainees under Article 20 (Students and Trainees), and the income of diplomatic agents and consular officers under Article 27 (Members of Diplomatic Missions and Consular Posts).

#### *Paragraph 6*

Paragraph 6 addresses special issues presented by fiscally transparent entities such as partnerships and certain estates and trusts. Because countries may take different views as to when an entity is fiscally transparent, the risk of both double taxation and double non-taxation is relatively high. The intention of paragraph 6 is to eliminate a number of technical problems that arguably would have prevented investors using such entities from claiming treaty benefits, even though such investors would be subject to tax on the income derived through such entities. The provision also prevents the use of such entities to claim treaty benefits in circumstances where the person investing through such an entity is not subject to tax on the income in its State of residence. The provision, and the corresponding requirements of the substantive rules of Articles 6 through 21, should be read with those two goals in mind.

In general, paragraph 6 relates to entities that are not subject to tax at the entity level, as distinct from entities that are subject to tax, but with respect to which tax may be relieved under an integrated system. This paragraph applies to any resident of a Contracting State who is entitled to income derived through an entity that is treated as fiscally transparent under the laws of either Con-

tracting State. Entities falling under this description in the United States include partnerships, common investment trusts under section 584, and grantor trusts. This paragraph also applies to U.S. limited liability companies (“LLCs”) that are treated as partnerships or as disregarded entities for U.S. tax purposes.

Under paragraph 6, an item of income, profit or gain derived by such a fiscally transparent entity will be considered to be derived by a resident of a Contracting State if a resident is treated under the taxation laws of that State as deriving the item of income. For example, if a company that is a resident of Malta pays interest to an entity that is treated as fiscally transparent for U.S. tax purposes, the interest will be considered derived by a resident of the U.S. only to the extent that the taxation laws of the United States treats one or more U.S. residents (whose status as U.S. residents is determined, for this purpose, under U.S. tax law) as deriving the interest for U.S. tax purposes. In the case of a partnership, the persons who are, under U.S. tax laws, treated as partners of the entity would normally be the persons whom the U.S. tax laws would treat as deriving the interest income through the partnership. Also, it follows that persons whom the United States treats as partners but who are not U.S. residents for U.S. tax purposes may not claim a benefit for the interest paid to the entity under the Convention, because they are not residents of the United States for purposes of claiming this treaty benefit. (If, however, the country in which they are treated as resident for tax purposes, as determined under the laws of that country, has an income tax convention with Malta, they may be entitled to claim a benefit under that convention.) In contrast, if, for example, an entity is organized under U.S. laws and is classified as a corporation for U.S. tax purposes, interest paid by a company that is a resident of Malta to the U.S. entity will be considered derived by a resident of the United States since the U.S. corporation is treated under U.S. taxation laws as a resident of the United States and as deriving the income.

The same result obtains even if the entity were viewed differently under the tax laws of Malta (e.g., as not fiscally transparent in the first example above where the entity is treated as a partnership for U.S. tax purposes). Similarly, the characterization of the entity in a third country is also irrelevant, even if the entity is organized in that third country. The results follow regardless of whether the entity is disregarded as a separate entity under the laws of one jurisdiction but not the other, such as a single owner entity that is viewed as a branch for U.S. tax purposes and as a corporation for tax purposes under the laws of Malta. These results also obtain regardless of where the entity is organized (i.e., in the United States, in Malta or, as noted above, in a third country).

For example, income from U.S. sources received by an entity organized under the laws of the United States, which is treated for tax purposes under the laws of Malta as a corporation and is owned by a shareholder who is a resident of Malta for its tax purposes, is not considered derived by the shareholder of that corporation even if, under the tax laws of the United States, the entity is treated as fiscally transparent. Rather, for purposes of the treaty, the income is treated as derived by the U.S. entity.

These principles also apply to trusts to the extent that they are fiscally transparent in either Contracting State. For example, if X, a resident of Malta, creates a revocable trust in the United States and names persons resident in a third country as the beneficiaries of the trust, the trust's income would be regarded as being derived by a resident of Malta only to the extent that the laws of Malta treat X as deriving the income for its tax purposes, perhaps through application of rules similar to the U.S. "grantor trust" rules.

Paragraph 6 is not an exception to the saving clause of paragraph 4. Accordingly, paragraph 6 does not prevent a Contracting State from taxing an entity that is treated as a resident of that State under its tax law. For example, if a U.S. LLC with members who are residents of Malta elects to be taxed as a corporation for U.S. tax purposes, the United States will tax that LLC on its worldwide income on a net basis, without regard to whether Malta views the LLC as fiscally transparent.

#### ARTICLE 2 (TAXES COVERED)

This Article specifies the U.S. taxes and the taxes of Malta to which the Convention applies. With two exceptions, the taxes specified in Article 2 are the covered taxes for all purposes of the Convention. A broader coverage applies, however, for purposes of Articles 24 (Non-Discrimination) and 26 (Exchange of Information and Administrative Assistance). Article 24 (Non-Discrimination) applies with respect to all taxes, including those imposed by state and local governments. Article 26 (Exchange of Information and Administrative Assistance) applies with respect to all taxes imposed at the national level.

##### *Paragraph 1*

Paragraph 1 identifies the category of taxes to which the Convention applies. Paragraph 1 is based on the U.S. and OECD Models and defines the scope of application of the Convention. The Convention applies to taxes on income, including gains, imposed on behalf of a Contracting State, irrespective of the manner in which they are levied. Except with respect to Article 24 (Non-Discrimination), state and local taxes are not covered by the Convention.

##### *Paragraph 2*

Paragraph 2 also is based on the U.S. and OECD Models and provides a definition of taxes on income and on capital gains. The Convention covers taxes on total income or any part of income and includes tax on gains derived from the alienation of property. The Convention does not apply, however, to social security charges, or any other charges where there is a direct connection between the levy and individual benefits. Nor does it apply to property taxes, except with respect to Article 24 (Non-Discrimination).

##### *Paragraph 3*

Paragraph 3 lists the taxes in force at the time of signature of the Convention to which the Convention applies.

The existing covered taxes of Malta are identified in subparagraph 3(a) as the income tax.

Subparagraph 3(b) provides that the existing U.S. taxes subject to the rules of the Convention are the Federal income taxes imposed by the Code, together with the excise taxes imposed with respect to private foundations (Code sections 4940 through 4948). Social security and unemployment taxes (Code sections 1401, 3101, 3111 and 3301) are specifically excluded from coverage.

*Paragraph 4*

Under paragraph 4, the Convention will apply to any taxes that are identical, or substantially similar, to those enumerated in paragraph 3, and which are imposed in addition to, or in place of, the existing taxes after August 8, 2008, the date of signature of the Convention. The paragraph also provides that the competent authorities of the Contracting States will notify each other of any changes that have been made in their laws, whether tax laws or non-tax laws, that affect significantly their obligations under the Convention. Non-tax laws that may affect a Contracting State's obligations under the Convention may include, for example, laws affecting bank secrecy.

ARTICLE 3 (GENERAL DEFINITIONS)

Article 3 provides general definitions and rules of interpretation applicable throughout the Convention. Certain other terms are defined in other articles of the Convention. For example, the term "resident of a Contracting State" is defined in Article 4 (Resident). The term "permanent establishment" is defined in Article 5 (Permanent Establishment). These definitions are used consistently throughout the Convention. Other terms, such as "dividends," "interest" and "royalties" are defined in specific articles for purposes only of those articles.

*Paragraph 1*

Paragraph 1 defines a number of basic terms used in the Convention. The introduction to paragraph 1 makes clear that these definitions apply for all purposes of the Convention, unless the context requires otherwise. This latter condition allows flexibility in the interpretation of the treaty in order to avoid results not intended by the treaty's negotiators.

Subparagraph 1(a) defines the term "person" to include an individual, a trust, a partnership, a company and any other body of persons. The definition is significant for a variety of reasons. For example, under Article 4, only a "person" can be a "resident" and therefore eligible for most benefits under the treaty. Also, all "persons" are eligible to claim relief under Article 25 (Mutual Agreement Procedure).

The term "company" is defined in subparagraph 1(b) as a body corporate or an entity treated as a body corporate for tax purposes in the state where it is organized. The definition refers to the law of the state in which an entity is organized in order to ensure that an entity that is treated as fiscally transparent in its country of residence will not get inappropriate benefits, such as the reduced withholding rate provided by subparagraph 2(a)(i) of Article 10 (Dividends). It also ensures that the Limitation on Benefits provisions of Article 22 will be applied at the appropriate level.

The terms “enterprise of a Contracting State” and “enterprise of the other Contracting State” are defined in subparagraph 1(c) as an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State. An enterprise of a Contracting State need not be carried on in that State. It may be carried on in the other Contracting State or a third state (e.g., a U.S. corporation doing all of its business in the other Contracting State would still be a U.S. enterprise).

Subparagraph 1(c) further provides that these terms also encompass an enterprise conducted through an entity (such as a partnership) that is treated as fiscally transparent in the Contracting State where the entity’s owner is resident. The definition makes this point explicitly to ensure that the purpose of the Convention is not thwarted by an overly technical application of the term “enterprise of a Contracting State” to activities carried on through partnerships and similar entities. In accordance with Article 4 (Resident), entities that are fiscally transparent in the country in which their owners are resident are not considered to be residents of a Contracting State (although income derived by such entities may be taxed as the income of a resident, if taxed in the hands of resident partners or other owners). It could be argued that an enterprise conducted by such an entity is not conducted by a resident of a Contracting State, and therefore would not benefit from provisions applicable to enterprises of a Contracting State. The definition is intended to make clear that an enterprise conducted by such an entity will be treated as carried on by a resident of a Contracting State to the extent its partners or other owners are residents. This approach is consistent with the Code, which under section 875 attributes a trade or business conducted by a partnership to its partners and a trade or business conducted by an estate or trust to its beneficiaries.

Subparagraph (d) defines the term “enterprise” as any activity or set of activities that constitutes the carrying on of a business. The term “business” is not defined, but subparagraph (e) provides that it includes the performance of professional services and other activities of an independent character. Both subparagraphs are identical to definitions added to the OECD Model in connection with the deletion of Article 14 (Independent Personal Services) from the OECD Model. The inclusion of the two definitions is intended to clarify that income from the performance of professional services or other activities of an independent character is dealt with under Article 7 (Business Profits) and not Article 21 (Other Income).

Subparagraph 1(f) defines the term “international traffic.” The term means any transport by a ship or aircraft except when such transport is solely between places within a Contracting State. This definition is applicable principally in the context of Article 8 (Shipping and Air Transport). The definition combines with paragraphs 2 and 3 of Article 8 to exempt from tax by the source State income from the rental of ships or aircraft that is earned both by lessors that are operators of ships and aircraft and by those lessors that are not (e.g., a bank or a container leasing company).

The exclusion from international traffic of transport solely between places within a Contracting State means, for example, that carriage of goods or passengers solely between New York and Chi-

cago would not be treated as international traffic, whether carried by a U.S. or a foreign carrier. The substantive taxing rules of the Convention relating to the taxation of income from transport, principally Article 8 (Shipping and Air Transport), therefore, would not apply to income from such carriage. Thus, if the carrier engaged in internal U.S. traffic were a resident of Malta (assuming that were possible under U.S. law), the United States would not be required to exempt the income from that transport under Article 8. The income would, however, be treated as business profits under Article 7 (Business Profits), and therefore would be taxable in the United States only if attributable to a U.S. permanent establishment of the foreign carrier, and then only on a net basis. The gross basis U.S. tax imposed by section 887 would never apply under the circumstances described. If, however, goods or passengers are carried by a carrier resident in Malta from a non-U.S. port to, for example, New York, and some of the goods or passengers continue on to Chicago, the entire transport would be international traffic. This would be true if the international carrier transferred the goods at the U.S. port of entry from a ship to a land vehicle, from a ship to a lighter, or even if the overland portion of the trip in the United States was handled by an independent carrier under contract with the original international carrier, so long as both parts of the trip were reflected in original bills of lading. For this reason, the Convention, following the U.S. Model, refers, in the definition of "international traffic," to "such transport" being solely between places in the other Contracting State, while the OECD Model refers to the ship or aircraft being operated solely between such places. The formulation in the Convention is intended to make clear that, as in the above example, even if the goods are carried on a different aircraft for the internal portion of the international voyage than is used for the overseas portion of the trip, the definition applies to that internal portion as well as the external portion.

Finally, a "cruise to nowhere," i.e., a cruise beginning and ending in a port in the same Contracting State with no stops in a foreign port, would not constitute international traffic.

Subparagraph 1(g) designates the "competent authorities" for the other Contracting State and the United States. The U.S. competent authority is the Secretary of the Treasury or his delegate. The Secretary of the Treasury has delegated the competent authority function to the Commissioner of Internal Revenue, who in turn has delegated the authority to the Deputy Commissioner (International) LMSB. With respect to interpretative issues, the Deputy Commissioner (International) LMSB acts with the concurrence of the Associate Chief Counsel (International) of the Internal Revenue Service. In the case of Malta, the competent authority is the Minister responsible for finance or his authorized representative.

The geographical scope of the Convention with respect to the United States is set out in subparagraph 1(h). It encompasses the United States of America, including the states, the District of Columbia and the territorial sea of the United States. The term does not include Puerto Rico, the Virgin Islands, Guam or any other U.S. possession or territory. For certain purposes, the term "United States" includes the sea bed and subsoil of undersea areas adjacent to the territorial sea of the United States. This extension applies



to the extent that the United States exercises sovereignty in accordance with international law for the purpose of natural resource exploration and exploitation of such areas. This extension of the definition applies, however, only if the person, property or activity to which the Convention is being applied is connected with such natural resource exploration or exploitation. Thus, it would not include any activity involving the sea floor of an area over which the United States exercised sovereignty for natural resource purposes if that activity was unrelated to the exploration and exploitation of natural resources. This result is consistent with the result that would be obtained under Section 638, which treats the continental shelf as part of the United States for purposes of natural resource exploration and exploitation.

The geographical scope of the Convention with respect to Malta is set out in subparagraph 1(i). The term “Malta” means the Republic of Malta and, when used in a geographical sense, means the island of Malta, the Island of Gozo, and the other islands of the Maltese archipelago including the territorial waters thereof as well as any area of the sea-bed, its sub-soil and the superjacent water column adjacent to the territorial waters, where the Republic of Malta exercises sovereign rights, jurisdiction or control in accordance with international law and its national law, including its legislation relating to the exploration of the Continental Shelf and exploitation of its natural resources.

The term “national,” as it relates to the United States and to Malta, is defined in subparagraph 1(j). This term is relevant for purposes of Articles 19 (Government Service) and 24 (Non-Discrimination). A national of one of the Contracting States is (1) an individual who is a citizen or national of that State, and (2) any legal person, partnership or association deriving its status, as such, from the law in force in the State where it is established.

Subparagraph (k) defines the term “pension fund” to include any person established in a Contracting State that, in the case of the United States, is generally exempt from income taxation, and in the case of Malta, is a licensed fund or scheme subject to tax only on income derived from immovable property situated in Malta, and that is operated principally to provide pension or retirement benefits or to earn income for the benefit of one or more such arrangements. In the case of the United States, the term “pension fund” includes the following: a trust providing pension or retirement benefits under a Code section 401(a) qualified pension plan, profit sharing or stock bonus plan, Code section 403(a) qualified annuity plan, a Code section 403(b) plan, a trust that is an individual retirement account under Code section 408, a Roth individual retirement account under Code section 408A, or a simple retirement account under Code section 408(p), a trust providing pension or retirement benefits under a simplified employee pension plan under Code section 408(k), a trust described in section 457(g) providing pension or retirement benefits under a Code section 457(b) plan, and the Thrift Savings Fund (section 7701(j)). Section 401(k) plans and group trusts described in Revenue Ruling 81-100 and meeting the conditions of Revenue Ruling 2004-67 qualify as pension funds to the extent that they are Code section 401(a) plans and other pension funds.

*Paragraph 2*

Terms that are not defined in the Convention are dealt with in paragraph 2.

Paragraph 2 provides that in the application of the Convention, any term used but not defined in the Convention will have the meaning that it has under the law of the Contracting State whose tax is being applied, unless the context requires otherwise, or the competent authorities have agreed on a different meaning pursuant to Article 25 (Mutual Agreement Procedure). If the term is defined under both the tax and non-tax laws of a Contracting State, the definition in the tax law will take precedence over the definition in the non-tax laws. Finally, there also may be cases where the tax laws of a State contain multiple definitions of the same term. In such a case, the definition used for purposes of the particular provision at issue, if any, should be used.

If the meaning of a term cannot be readily determined under the law of a Contracting State, or if there is a conflict in meaning under the laws of the two States that creates difficulties in the application of the Convention, the competent authorities, as indicated in paragraph 3(c)(iv) of Article 25 (Mutual Agreement Procedure), may establish a common meaning in order to prevent double taxation or to further any other purpose of the Convention. This common meaning need not conform to the meaning of the term under the laws of either Contracting State.

The reference in paragraph 2 to the internal law of a Contracting State means the law in effect at the time the treaty is being applied, not the law as in effect at the time the treaty was signed. The use of “ambulatory” definitions, however, may lead to results that are at variance with the intentions of the negotiators and of the Contracting States when the treaty was negotiated and ratified. The reference in both paragraphs 1 and 2 to the “context otherwise requir[ing]” a definition different from the treaty definition, in paragraph 1, or from the internal law definition of the Contracting State whose tax is being imposed, under paragraph 2, refers to a circumstance where the result intended by the Contracting States is different from the result that would obtain under either the paragraph 1 definition or the statutory definition. Thus, flexibility in defining terms is necessary and permitted.

## ARTICLE 4 (RESIDENT)

This Article sets forth rules for determining whether a person is a resident of a Contracting State for purposes of the Convention. As a general matter only residents of the Contracting States may claim the benefits of the Convention. The treaty definition of residence is to be used only for purposes of the Convention. The fact that a person is determined to be a resident of a Contracting State under Article 4 does not necessarily entitle that person to the benefits of the Convention. In addition to being a resident, a person also must qualify for benefits under Article 22 (Limitation on Benefits) in order to receive benefits conferred on residents of a Contracting State.

The determination of residence for treaty purposes looks first to a person’s liability to tax as a resident under the respective tax-

ation laws of the Contracting States. As a general matter, a person who, under those laws, is a resident of one Contracting State and not of the other need look no further. For purposes of the Convention, that person is a resident of the State in which he is resident under internal law. If, however, a person is resident in both Contracting States under their respective taxation laws, the Article proceeds, where possible, to use tie-breaker rules to assign a single State of residence to such a person for purposes of the Convention.

*Paragraph 1*

The term “resident of a Contracting State” is defined in paragraph 1. In general, this definition incorporates the definitions of residence in U.S. law and that of Malta by referring to a resident as a person who, under the laws of a Contracting State, is subject to tax there by reason of his domicile, residence, citizenship, place of management, place of incorporation or any other similar criterion. Thus, residents of the United States include aliens who are considered U.S. residents under Code section 7701(b). Paragraph 1 also specifically includes the two Contracting States, and political subdivisions and local authorities of the two States, as residents for purposes of the Convention.

Certain entities that are nominally subject to tax but that in practice are rarely required to pay tax also would generally be treated as residents and therefore accorded treaty benefits. For example, a U.S. Regulated Investment Company (RIC) and a U.S. Real Estate Investment Trust (REIT) are residents of the United States for purposes of the treaty. Although the income earned by these entities normally is not subject to U.S. tax in the hands of the entity, they are taxable to the extent that they do not currently distribute their profits, and therefore may be regarded as liable to tax. They also must satisfy a number of requirements under the Code in order to be entitled to special tax treatment.

A person who is liable to tax in a Contracting State only in respect of income from sources within that State or capital situated therein or of profits attributable to a permanent establishment in that State will not be treated as a resident of that Contracting State for purposes of the Convention. Thus, a consular official of Malta who is posted in the United States, who may be subject to U.S. tax on U.S. source investment income, but is not taxable in the United States on non-U.S. source income (see Code section 7701(b)(5)(B)), would not be considered a resident of the United States for purposes of the Convention. Similarly, an enterprise of Malta with a permanent establishment in the United States is not, by virtue of that permanent establishment, a resident of the United States. The enterprise generally is subject to U.S. tax only with respect to its income that is attributable to the U.S. permanent establishment, not with respect to its worldwide income, as it would be if it were a U.S. resident.

*Paragraph 2*

Paragraph 2 provides that certain tax-exempt entities such as pension funds and charitable organizations will be regarded as residents of a Contracting State regardless of whether they are generally liable to income tax in the State where they are estab-

lished. The paragraph applies to legal persons organized under the laws of a Contracting State and established and maintained in that State to provide pensions or other similar benefits pursuant to a plan, or exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes. Thus, a section 501(c) organization organized in the United States (such as a U.S. charity) that is generally exempt from tax under U.S. law is a resident of the United States for all purposes of the Convention. In the case of Malta, the Exchange of Notes accompanying the Convention provides that paragraph 2 applies to entities exempt from taxation under Maltese law as philanthropic institutions, philharmonic societies, or sports clubs.

*Paragraph 3*

If, under the laws of the two Contracting States, and, thus, under paragraph 1, an individual is deemed to be a resident of both Contracting States, a series of tie-breaker rules are provided in paragraph 3 to determine a single State of residence for that individual. These tests are to be applied in the order in which they are stated. The first test is based on where the individual has a permanent home. If that test is inconclusive because the individual has a permanent home available to him in both States, he will be considered to be a resident of the Contracting State where his personal and economic relations are closest (i.e., the location of his “center of vital interests”). If that test is also inconclusive, or if he does not have a permanent home available to him in either State, he will be treated as a resident of the Contracting State where he maintains a habitual abode. If he has a habitual abode in both States or in neither of them, he will be treated as a resident of the Contracting State of which he is a national. If he is a national of both States or of neither, the matter will be considered by the competent authorities, who will assign a single State of residence.

*Paragraph 4*

Paragraph 4 seeks to settle dual-residence issues for companies. A company is treated as resident in the United States if it is created or organized under the laws of the United States or a political subdivision. Because a company can be treated as a resident of Malta if it is either incorporated or managed and controlled there, dual residence can arise in the case of a U.S. company that is managed and controlled in Malta. In other cases, a company may be a dual resident because it was originally incorporated in one Contracting State but has “continued” into the other Contracting State. Paragraph 4 attempts to deal with each of these situations.

Under paragraph 4, the residence of a dual-resident company will be in the Contracting State under the laws of which it is created or organized if it is created or organized under the laws of only one of the other Contracting States. Thus, if a company is a resident of the United States because it is incorporated under the laws of one of the states and is a resident of Malta because its place of effective management is in Malta, then it will be a resident only of the United States. However, if the incorporation test does not resolve the question because, for example, the company was incorporated in one Contracting State and continued into the other

Contracting State, but the first-mentioned Contracting State does not recognize the migration and continues to treat the company as a resident, then the competent authorities will try to determine a single State of residence for the company.

If the competent authorities do not reach an agreement on a single State of residence, that company may not claim any benefit accorded to residents of a Contracting State by the Convention. The company may, however, claim any benefits that are not limited to residents, such as those provided by paragraph 1 of Article 24 (Non-Discrimination). Thus, for example, a State cannot discriminate against a dual resident company.

Dual resident companies also may be treated as a resident of a Contracting State for purposes other than that of obtaining benefits under the Convention. For example, if a dual resident company pays a dividend to a resident of Malta, the U.S. paying agent would withhold on that dividend at the appropriate treaty rate because reduced withholding is a benefit enjoyed by the resident of Malta, not by the dual resident company. The dual resident company that paid the dividend would, for this purpose, be treated as a resident of the United States under the Convention. In addition, information relating to dual resident companies can be exchanged under the Convention because, by its terms, Article 26 (Exchange of Information and Administrative Assistance) is not limited to residents of the Contracting States.

*Paragraph 5*

Dual residents other than individuals or companies (such as trusts or estates) are addressed by paragraph 5. If such a person is, under the rules of paragraph 1, resident in both Contracting States, the competent authorities shall seek to determine a single State of residence for that person for purposes of the Convention.

ARTICLE 5 (PERMANENT ESTABLISHMENT)

This Article defines the term “permanent establishment,” a term that is significant for several articles of the Convention. The existence of a permanent establishment in a Contracting State is necessary under Article 7 (Business Profits) for the taxation by that State of the business profits of a resident of the other Contracting State. Articles 10 (Dividends), 11 (Interest), and 12 (Royalties) provide for reduced rates of tax at source on payments of these items of income to a resident of the other State only when the income is not attributable to a permanent establishment that the recipient has in the source State. The concept is also relevant in determining which Contracting State may tax certain gains under Article 13 (Gains) and certain “other income” under Article 21 (Other Income).

*Paragraph 1*

The basic definition of the term “permanent establishment” is contained in paragraph 1. As used in the Convention, the term means a fixed place of business through which the business of an enterprise is wholly or partly carried on. As indicated in the OECD Commentary to Article 5 (see paragraphs 4 through 8), a general principle to be observed in determining whether a permanent es-

establishment exists is that the place of business must be “fixed” in the sense that a particular building or physical location is used by the enterprise for the conduct of its business, and that it must be foreseeable that the enterprise’s use of this building or other physical location will be more than temporary.

*Paragraph 2*

Paragraph 2 lists a number of types of fixed places of business that constitute a permanent establishment. This list is illustrative and non-exclusive. According to paragraph 2, the term permanent establishment includes a place of management, a branch, an office, a factory, a workshop, and a mine, oil or gas well, quarry or other place of extraction of natural resources.

*Paragraph 3*

This paragraph provides rules to determine whether a building site or a construction, assembly or installation project, or an installation or drilling rig or ship used for the exploration of natural resources constitutes a permanent establishment for the contractor, driller, etc. Such a site or activity does not create a permanent establishment unless the site, project, etc. lasts, or the exploration activity continues, for more than twelve months. It is only necessary to refer to “exploration” and not “exploitation” in this context because exploitation activities are defined to constitute a permanent establishment under subparagraph 2(f). Thus, a drilling rig does not constitute a permanent establishment if a well is drilled in only six months, but if production begins in the following month the well becomes a permanent establishment as of that date.

The twelve-month test applies separately to each site or project. The twelve-month period begins when work (including preparatory work carried on by the enterprise) physically begins in a Contracting State. A series of contracts or projects by a contractor that are interdependent both commercially and geographically are to be treated as a single project for purposes of applying the twelve-month threshold test. For example, the construction of a housing development would be considered as a single project even if each house were constructed for a different purchaser.

In applying this paragraph, time spent by a sub-contractor on a building site is counted as time spent by the general contractor at the site for purposes of determining whether the general contractor has a permanent establishment. However, for the sub-contractor itself to be treated as having a permanent establishment, the sub-contractor’s activities at the site must last for more than 12 months. If a sub-contractor is on a site intermittently, then, for purposes of applying the 12-month rule, time is measured from the first day the sub-contractor is on the site until the last day (i.e., intervening days that the sub-contractor is not on the site are counted).

These interpretations of the Article are based on the Commentary to paragraph 3 of Article 5 of the OECD Model, which contains language that is substantially the same as that in the Convention. These interpretations are consistent with the generally accepted international interpretation of the relevant language in paragraph 3 of Article 5 of the Convention.

If the twelve-month threshold is exceeded, the site or project constitutes a permanent establishment from the first day of activity.

*Paragraph 4*

This paragraph contains exceptions to the general rule of paragraph 1, listing a number of activities that may be carried on through a fixed place of business but which nevertheless do not create a permanent establishment. The use of facilities solely to store, display or deliver merchandise belonging to an enterprise does not constitute a permanent establishment of that enterprise. The maintenance of a stock of goods belonging to an enterprise solely for the purpose of storage, display or delivery, or solely for the purpose of processing by another enterprise does not give rise to a permanent establishment of the first-mentioned enterprise. The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or for collecting information, for the enterprise, or for other activities that have a preparatory or auxiliary character for the enterprise, such as advertising, or the supply of information, do not constitute a permanent establishment of the enterprise. Moreover, subparagraph 4(f) provides that a combination of the activities described in the other subparagraphs of paragraph 4 will not give rise to a permanent establishment if the combination results in an overall activity that is of a preparatory or auxiliary character.

*Paragraph 5*

Paragraphs 5 and 6 specify when activities carried on by an agent or other person acting on behalf of an enterprise create a permanent establishment of that enterprise. Under paragraph 5, a person is deemed to create a permanent establishment of the enterprise if that person has and habitually exercises an authority to conclude contracts that are binding on the enterprise. If, however, for example, his activities are limited to those activities specified in paragraph 4 which would not constitute a permanent establishment if carried on by the enterprise through a fixed place of business, the person does not create a permanent establishment of the enterprise.

The Convention uses the U.S. Model language “binding on the enterprise,” rather than the OECD Model language “in the name of that enterprise.” This difference in language is not intended to be a substantive difference. As indicated in paragraph 32 to the OECD Commentaries on Article 5, paragraph 5 of the Article is intended to encompass persons who have “sufficient authority to bind the enterprise’s participation in the business activity in the State concerned.”

The contracts referred to in paragraph 5 are those relating to the essential business operations of the enterprise, rather than ancillary activities. For example, if the person has no authority to conclude contracts in the name of the enterprise with its customers for, say, the sale of the goods produced by the enterprise, but it can enter into service contracts in the name of the enterprise for the enterprise’s business equipment, this contracting authority would not fall within the scope of the paragraph, even if exercised regularly.

*Paragraph 6*

Under paragraph 6, an enterprise is not deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through an independent agent, including a broker or general commission agent, if the agent is acting in the ordinary course of his business as an independent agent. Thus, there are two conditions that must be satisfied: the agent must be both legally and economically independent of the enterprise, and the agent must be acting in the ordinary course of its business in carrying out activities on behalf of the enterprise.

Whether the agent and the enterprise are independent is a factual determination. Among the questions to be considered are the extent to which the agent operates on the basis of instructions from the enterprise. An agent that is subject to detailed instructions regarding the conduct of its operations or comprehensive control by the enterprise is not legally independent.

In determining whether the agent is economically independent, a relevant factor is the extent to which the agent bears business risk. Business risk refers primarily to risk of loss. An independent agent typically bears risk of loss from its own activities. In the absence of other factors that would establish dependence, an agent that shares business risk with the enterprise, or has its own business risk, is economically independent because its business activities are not integrated with those of the principal. Conversely, an agent that bears little or no risk from the activities it performs is not economically independent and therefore is not described in paragraph 6.

Another relevant factor in determining whether an agent is economically independent is whether the agent acts exclusively or nearly exclusively for the principal. Such a relationship may indicate that the principal has economic control over the agent. A number of principals acting in concert also may have economic control over an agent. The limited scope of the agent's activities and the agent's dependence on a single source of income may indicate that the agent lacks economic independence. It should be borne in mind, however, that exclusivity is not in itself a conclusive test; an agent may be economically independent notwithstanding an exclusive relationship with the principal if it has the capacity to diversify and acquire other clients without substantial modifications to its current business and without substantial harm to its business profits. Thus, exclusivity should be viewed merely as a pointer to further investigation of the relationship between the principal and the agent. Each case must be addressed on the basis of its own facts and circumstances.

*Paragraph 7*

This paragraph clarifies that a company that is a resident of a Contracting State is not deemed to have a permanent establishment in the other Contracting State merely because it controls, or is controlled by, a company that is a resident of that other Contracting State, or that carries on business in that other Contracting State. The determination whether a permanent establishment exists is made solely on the basis of the factors described in paragraphs 1 through 6 of the Article. Whether a company is a perma-



ment establishment of a related company, therefore, is based solely on those factors and not on the ownership or control relationship between the companies.

ARTICLE 6 (INCOME FROM REAL (IMMOVABLE) PROPERTY)

This article deals with the taxation of income from real (immovable) property situated in a Contracting State (the “situs State”). The Article does not grant an exclusive taxing right to the situs State; the situs State is merely given the primary right to tax. The Article does not impose any limitation in terms of rate or form of tax imposed by the situs State, except that, as provided in paragraph 5, the situs State must allow the taxpayer an election to be taxed on a net basis.

*Paragraph 1*

The first paragraph of Article 6 states the general rule that income of a resident of a Contracting State derived from real (immovable) property situated in the other Contracting State may be taxed in the Contracting State in which the property is situated. The paragraph specifies that income from real (immovable) property includes income from agriculture and forestry. Given the availability of the net election in paragraph 5, taxpayers generally should be able to obtain the same tax treatment in the situs country regardless of whether the income is treated as business profits or real (immovable) property income.

*Paragraph 2*

The term “real (immovable) property” is defined in paragraph 2 by reference to the internal law definition in the situs State. In the case of the United States, the term has the meaning given to it by Reg. § 1.897-1(b). In addition to the statutory definitions in the two Contracting States, the paragraph specifies certain additional classes of property that, regardless of internal law definitions, are within the scope of the term for purposes of the Convention. This expanded definition conforms to that in the OECD Model. The definition of “real (immovable) property” for purposes of Article 6 is more limited than the expansive definition of “real (immovable) property” in paragraph 1 of Article 13 (Capital Gains). The Article 13 term includes not only real (immovable) property as defined in Article 6 but certain other interests in real (immovable) property.

*Paragraph 3*

Paragraph 3 makes clear that all forms of income derived from the exploitation of real (immovable) property are taxable in the Contracting State in which the property is situated. This includes income from any use of real (immovable) property, including, but not limited to, income from direct use by the owner (in which case income may be imputed to the owner for tax purposes) and rental income from the letting of real (immovable) property. In the case of a net lease of real (immovable) property, if a net election pursuant to paragraph 5 has not been made, the gross rental payment (before deductible expenses incurred by the lessee) is treated as income from the property.

Other income closely associated with real (immovable) property is covered by other Articles of the Convention, however, and not Article 6. For example, income from the disposition of an interest in real (immovable) property is not considered “derived” from real (immovable) property; taxation of that income is addressed in Article 13 (Gains). Interest paid on a mortgage on real (immovable) property would be covered by Article 11 (Interest). Distributions by a U.S. Real Estate Investment Trust or certain regulated investment companies would fall under Article 13 in the case of distributions of U.S. real property gain or Article 10 (Dividends) in the case of distributions treated as dividends. Finally, distributions from a United States Real Property Holding Corporation are not considered to be income from the exploitation of real (immovable) property; such payments would fall under Article 10 or 13.

*Paragraph 4*

This paragraph specifies that the basic rule of paragraph 1 (as elaborated in paragraph 3) applies to income from real (immovable) property of an enterprise. This clarifies that the situs country may tax the real (immovable) property income (including rental income) of a resident of the other Contracting State in the absence of attribution to a permanent establishment in the situs State. This provision represents an exception to the general rule under Articles 7 (Business Profits) that income must be attributable to a permanent establishment in order to be taxable in the situs State.

*Paragraph 5*

The paragraph provides that a resident of one Contracting State that derives real (immovable) property income from the other may elect, for any taxable year, to be subject to tax in that other State on a net basis, as though the income were attributable to a permanent establishment in that other State. In the case of real property situated in the United States, the election may be terminated only with the consent of the competent authority of the United States. Termination of such election will be granted in accordance with the provisions of Treas. Reg. § 1.871–10(d)(2).

ARTICLE 7 (BUSINESS PROFITS)

This Article provides rules for the taxation by a Contracting State of the business profits of an enterprise of the other Contracting State.

*Paragraph 1*

Paragraph 1 states the general rule that business profits of an enterprise of one Contracting State may not be taxed by the other Contracting State unless the enterprise carries on business in that other Contracting State through a permanent establishment (as defined in Article 5 (Permanent Establishment)) situated there. When that condition is met, the State in which the permanent establishment is situated may tax the enterprise on the income that is attributable to the permanent establishment.

Although the Convention does not include a definition of “business profits,” the term is intended to cover income derived from any trade or business. In accordance with this broad definition, the

term “business profits” includes income attributable to notional principal contracts and other financial instruments to the extent that the income is attributable to a trade or business of dealing in such instruments or is otherwise related to a trade or business (as in the case of a notional principal contract entered into for the purpose of hedging currency risk arising from an active trade or business). Any other income derived from such instruments is, unless specifically covered in another article, dealt with under Article 21 (Other Income).

The term “business profits” also includes income derived by an enterprise from the rental of tangible personal property (unless such tangible personal property consists of aircraft, ships or containers, income from which is addressed by Article 8 (Shipping and Air Transport)). The inclusion of income derived by an enterprise from the rental of tangible personal property in business profits means that such income earned by a resident of a Contracting State can be taxed by the other Contracting State only if the income is attributable to a permanent establishment maintained by the resident in that other State, and, if the income is taxable, it can be taxed only on a net basis. Income from the rental of tangible personal property that is not derived in connection with a trade or business is dealt with in Article 21 (Other Income).

In addition, as a result of the definitions of “enterprise” and “business” in Article 3 (General Definitions), the term includes income derived from the furnishing of personal services. Thus, a consulting firm resident in one State whose employees or partners perform services in the other State through a permanent establishment may be taxed in that other State on a net basis under Article 7, and not under Article 14 (Income from Employment), which applies only to income of employees. With respect to the enterprise’s employees themselves, however, their salary remains subject to Article 14.

Because this article applies to income earned by an enterprise from the furnishing of personal services, the article also applies to income derived by a partner resident in a Contracting State that is attributable to personal services performed in the other Contracting State through a partnership with a permanent establishment in that other State. Income which may be taxed under this article includes all income attributable to the permanent establishment in respect of the performance of the personal services carried on by the partnership (whether by the partner himself, other partners in the partnership, or by employees assisting the partners) and any income from activities ancillary to the performance of those services (e.g., charges for facsimile services).

The application of Article 7 to a service partnership may be illustrated by the following example: a partnership formed in Malta has five partners (who agree to split profits equally), four of whom are resident and perform personal services only in Malta at Office A, and one of whom performs personal services at Office B, a permanent establishment in the United States. In this case, the four partners of the partnership resident in Malta may be taxed in the United States in respect of their share of the income attributable to the permanent establishment, Office B. The services giving rise to income which may be attributed to the permanent establishment

would include not only the services performed by the one resident partner, but also, for example, if one of the four other partners came to the United States and worked on an Office B matter there, the income in respect of those services. Income from the services performed by the visiting partner would be subject to tax in the United States regardless of whether the visiting partner actually visited or used Office B while performing services in the United States.

#### *Paragraph 2*

Paragraph 2 provides rules for the attribution of business profits to a permanent establishment. The Contracting States will attribute to a permanent establishment the profits that it would have earned had it been a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions. This language incorporates the arm's-length standard for purposes of determining the profits attributable to a permanent establishment. The computation of business profits attributable to a permanent establishment under this paragraph is subject to the rules of paragraph 3 for the allowance of expenses incurred for the purposes of earning the profits.

The "attributable to" concept of paragraph 2 is analogous but not entirely equivalent to the "effectively connected" concept in Code section 864(c). The profits attributable to a permanent establishment may be from sources within or without a Contracting State.

Paragraph 2 also provides that the business profits attributed to a permanent establishment include only those derived from the assets used, risks assumed and activities performed by the permanent establishment. This rule is consistent with the "asset-use" and "business activities" tests of Code section 864(c)(2).

#### *Paragraph 3*

Paragraph 3 provides that in determining the business profits of a permanent establishment, deductions shall be allowed for the expenses incurred for the purposes of the permanent establishment, ensuring that business profits will be taxed on a net basis. This rule is not limited to expenses incurred exclusively for the purposes of the permanent establishment, but includes expenses incurred for the purposes of the enterprise as a whole, or that part of the enterprise that includes the permanent establishment. Deductions are to be allowed regardless of which accounting unit of the enterprise books the expenses, so long as they are incurred for the purposes of the permanent establishment. For example, a portion of the interest expense recorded on the books of the home office in one State may be deducted by a permanent establishment in the other if properly allocable thereto. This rule permits (but does not require) each Contracting State to apply the type of expense allocation rules provided by U.S. law (such as in Treas. Reg. sections 1.861-8 and 1.882-5).

Paragraph 3 does not permit a deduction 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. Similarly, a permanent establishment may not increase its business profits by the amount of any notional fees for

ancillary services performed for another unit of the enterprise, but also should not receive a deduction for the expense of providing such services, since those expenses would be incurred for purposes of a business unit other than the permanent establishment.

*Paragraph 4*

Paragraph 4 provides that no business profits can be attributed to a permanent establishment merely because it purchases goods or merchandise for the enterprise of which it is a part. This paragraph is essentially identical to paragraph 5 of Article 7 of the OECD Model. This rule applies only to an office that performs functions for the enterprise in addition to purchasing. The income attribution issue does not arise if the sole activity of the office is the purchase of goods or merchandise because such activity does not give rise to a permanent establishment under Article 5 (Permanent Establishment). A common situation in which paragraph 4 is relevant is one in which a permanent establishment purchases raw materials for the enterprise's manufacturing operation conducted outside the United States and sells the manufactured product. While business profits may be attributable to the permanent establishment with respect to its sales activities, no profits are attributable to it with respect to its purchasing activities.

*Paragraph 5*

Paragraph 5 provides that profits shall be determined by the same method each year, unless there is good reason to change the method used. This rule assures consistent tax treatment over time for permanent establishments. It limits the ability of both the Contracting State and the enterprise to change accounting methods to be applied to the permanent establishment. It does not, however, restrict a Contracting State from imposing additional requirements, such as the rules under Code section 481, to prevent amounts from being duplicated or omitted following a change in accounting method.

*Paragraph 6*

Paragraph 6 coordinates the provisions of Article 7 and other provisions of the Convention. Under this paragraph, when business profits include items of income that are dealt with separately under other articles of the Convention, the provisions of those articles will, except when they specifically provide to the contrary, take precedence over the provisions of Article 7. For example, the taxation of dividends will be determined by the rules of Article 10 (Dividends), and not by Article 7, except where, as provided in paragraph 6 of Article 10, the dividend is attributable to a permanent establishment. In the latter case the provisions of Article 7 apply. Thus, an enterprise of one State deriving dividends from the other State may not rely on Article 7 to exempt those dividends from tax at source if they are not attributable to a permanent establishment of the enterprise in the other State. By the same token, if the dividends are attributable to a permanent establishment in the other State, the dividends may be taxed on a net income basis at the source State full corporate tax rate, rather than on a gross basis under Article 10.

As provided in Article 8 (Shipping and Air Transport), income derived from shipping and air transport activities in international traffic described in that Article is taxable only in the country of residence of the enterprise regardless of whether it is attributable to a permanent establishment situated in the source State.

*Paragraph 7*

Paragraph 7 incorporates into the Convention the rule of Code section 864(c)(6). Like the Code section on which it is based, paragraph 7 provides that any income or gain attributable to a permanent establishment during its existence is taxable in the Contracting State where the permanent establishment is situated, even if the payment of that income or gain is deferred until after the permanent establishment ceases to exist. This rule applies with respect to this Article, paragraph 6 of Article 10, paragraph 5 of Article 11 (Interest), paragraph 4 of Articles 12 (Royalties), paragraph 3 of Article 13 (Gains) and paragraph 2 of Article 21 (Other Income).

The effect of this rule can be illustrated by the following example. Assume a company that is a resident of the other Contracting State and that maintains a permanent establishment in the United States winds up the permanent establishment's business and sells the permanent establishment's inventory and assets to a U.S. buyer at the end of year 1 in exchange for an interest-bearing installment obligation payable in full at the end of year 3. Despite the fact that Article 13's threshold requirement for U.S. taxation is not met in year 3 because the company has no permanent establishment in the United States, the United States may tax the deferred income payment recognized by the company in year 3.

*Relationship to Other Articles*

This Article is subject to the saving clause of paragraph 4 of Article 1 (General Scope) of the Model. Thus, if a citizen of the United States who is a resident of Malta under the treaty derives business profits from the United States that are not attributable to a permanent establishment in the United States, the United States may, subject to the special foreign tax credit rules of paragraph 4 of Article 23 (Relief from Double Taxation), tax those profits, notwithstanding the provision of paragraph 1 of this Article which would exempt the income from U.S. tax.

The benefits of this Article are also subject to Article 22 (Limitation on Benefits). Thus, an enterprise of Malta and that derives income effectively connected with a U.S. trade or business may not claim the benefits of Article 7 unless the resident carrying on the enterprise qualifies for such benefits under Article 22.

ARTICLE 8 (SHIPPING AND AIR TRANSPORT)

This Article governs the taxation of profits from the operation of ships and aircraft in international traffic. The term "international traffic" is defined in subparagraph 1(f) of Article 3 (General Definitions). The Exchange of Notes accompanying the Convention provides that neither the provisions of Article 8 nor any other provision of the Convention shall affect the continued validity and application of the provisions of the Agreement between the United

States and Malta regarding the Taxation of Shipping and Aircraft effected by exchange of notes dated at Washington December 26, 1996, and March 11, 1997.

*Paragraph 1*

Paragraph 1 provides that profits derived by an enterprise of a Contracting State from the operation in international traffic of ships or aircraft are taxable only in that Contracting State. Because paragraph 6 of Article 7 (Business Profits) defers to Article 8 with respect to shipping income, such income derived by a resident of one of the Contracting States may not be taxed in the other State even if the enterprise has a permanent establishment in that other State. Thus, if a U.S. airline has a ticket office in Malta, Malta may not tax the airline's profits attributable to that office under Article 7. Since entities engaged in international transportation activities normally will have many permanent establishments in a number of countries, the rule avoids difficulties that would be encountered in attributing income to multiple permanent establishments if the income were covered by Article 7.

*Paragraph 2*

The income from the operation of ships or aircraft in international traffic that is exempt from tax under paragraph 1 is defined in paragraph 2.

In addition to income derived directly from the operation of ships and aircraft in international traffic, this definition also includes certain items of rental income. First, income of an enterprise of a Contracting State from the rental of ships or aircraft on a full basis (i.e., with crew) is income of the lessor from the operation of ships and aircraft in international traffic and, therefore, is exempt from tax in the other Contracting State under paragraph 1. Also, paragraph 2 encompasses income from the lease of ships or aircraft on a bareboat basis (i.e., without crew), either when the income is incidental to other income of the lessor from the operation of ships or aircraft in international traffic, or when the ships or aircraft are operated in international traffic by the lessee. If neither of those two conditions apply, income from the bareboat rentals would constitute business profits. The coverage of Article 8 is therefore broader than that of Article 8 of the OECD Model, which covers bareboat leasing only when it is incidental to other income of the lessor from the operation of ships or aircraft in international traffic.

Paragraph 2 also clarifies, consistent with the Commentary to Article 8 of the OECD Model, that income earned by an enterprise from the inland transport of property or passengers within either Contracting State falls within Article 8 if the transport is undertaken as part of the international transport of property or passengers by the enterprise. Thus, if a U.S. shipping company contracts to carry property from Malta to a U.S. city and, as part of that contract, it transports the property by truck from its point of origin to an airport in Malta (or it contracts with a trucking company to carry the property to the airport) the income earned by the U.S. shipping company from the overland leg of the journey would be taxable only in the United States. Similarly, Article 8 also would apply to all of the income derived from a contract for the inter-

national transport of goods, even if the goods were transported to the port by a lighter, not by the vessel that carried the goods in international waters.

Finally, certain non-transport activities that are an integral part of the services performed by a transport company, or are ancillary to the enterprise's operation of ships or aircraft in international traffic, are understood to be covered in paragraph 1, though they are not specified in paragraph 2. These include, for example, the provision of goods and services by engineers, ground and equipment maintenance and staff, cargo handlers, catering staff and customer services personnel. Where the enterprise provides such goods to, or performs services for, other enterprises and such activities are directly connected with or ancillary to the enterprise's operation of ships or aircraft in international traffic, the profits from the provision of such goods and services to other enterprises will fall under this paragraph.

For example, enterprises engaged in the operation of ships or aircraft in international traffic may enter into pooling arrangements for the purposes of reducing the costs of maintaining facilities needed for the operation of their ships or aircraft in other countries. For instance, where an airline enterprise agrees (for example, under an International Airlines Technical Pool agreement) to provide spare parts or maintenance services to other airlines landing at a particular location (which allows it to benefit from these services at other locations), activities carried on pursuant to that agreement will be ancillary to the operation of aircraft in international traffic by the enterprise.

Also, advertising that the enterprise may do for other enterprises in magazines offered aboard ships or aircraft that it operates in international traffic or at its business locations, such as ticket offices, is ancillary to its operation of these ships or aircraft. Profits generated by such advertising fall within this paragraph. Income earned by concessionaires, however, is not covered by Article 8. These interpretations of paragraph 1 also are consistent with the Commentary to Article 8 of the OECD Model.

### *Paragraph 3*

Under this paragraph, profits of an enterprise of a Contracting State from the use, maintenance or rental of containers (including equipment for their transport) are exempt from tax in the other Contracting State, unless those containers are used for transport solely in the other Contracting State. This result obtains under paragraph 3 regardless of whether the recipient of the income is engaged in the operation of ships or aircraft in international traffic, and regardless of whether the enterprise has a permanent establishment in the other Contracting State. Only income from the use, maintenance or rental of containers that is incidental to other income from international traffic is covered by Article 8 of the OECD Model.

### *Paragraph 4*

This paragraph clarifies that the provisions of paragraphs 1 and 3 also apply to profits derived by an enterprise of a Contracting State from participation in a pool, joint business or international



operating agency. This refers to various arrangements for international cooperation by carriers in shipping and air transport. For example, airlines from two countries may agree to share the transport of passengers between the two countries. They each will fly the same number of flights per week and share the revenues from that route equally, regardless of the number of passengers that each airline actually transports. Paragraph 4 makes clear that with respect to each carrier the income dealt with in the Article is that carrier's share of the total transport, not the income derived from the passengers actually carried by the airline. This paragraph corresponds to paragraph 4 of Article 8 of the OECD Model.

*Relationship to Other Articles*

The taxation of gains from the alienation of ships, aircraft or containers is not dealt with in this Article but in paragraph 4 of Article 13 (Gains).

As with other benefits of the Convention, the benefit of exclusive residence country taxation under Article 8 is available to an enterprise only if it is entitled to benefits under Article 22 (Limitation on Benefits).

This Article also is subject to the saving clause of paragraph 4 of Article 1 (General Scope) of the Model. Thus, if a citizen of the United States who is a resident of Malta derives profits from the operation of ships or aircraft in international traffic, notwithstanding the exclusive residence country taxation in paragraph 1 of Article 8, the United States may, subject to the special foreign tax credit rules of paragraph 4 of Article 23 (Relief from Double Taxation), tax those profits as part of the worldwide income of the citizen. (This is an unlikely situation, however, because non-tax considerations (e.g., insurance) generally result in shipping activities being carried on in corporate form.)

ARTICLE 9 (ASSOCIATED ENTERPRISES)

This Article incorporates in the Convention the arm's-length principle reflected in the U.S. domestic transfer pricing provisions, particularly Code section 482. It provides that when related enterprises engage in a transaction on terms that are not arm's-length, the Contracting States may make appropriate adjustments to the taxable income and tax liability of such related enterprises to reflect what the income and tax of these enterprises with respect to the transaction would have been had there been an arm's-length relationship between them.

*Paragraph 1*

This paragraph addresses the situation where an enterprise of a Contracting State is related to an enterprise of the other Contracting State, and there are arrangements or conditions imposed between the enterprises in their commercial or financial relations that are different from those that would have existed in the absence of the relationship. Under these circumstances, the Contracting States may adjust the income (or loss) of the enterprise to reflect what it would have been in the absence of such a relationship.

The paragraph identifies the relationships between enterprises that serve as a prerequisite to application of the Article. As the Commentary to the OECD Model makes clear, the necessary element in these relationships is effective control, which is also the standard for purposes of section 482. Thus, the Article applies if an enterprise of one State participates directly or indirectly in the management, control, or capital of the enterprise of the other State. Also, the Article applies if any third person or persons participate directly or indirectly in the management, control, or capital of enterprises of different States. For this purpose, all types of control are included, i.e., whether or not legally enforceable and however exercised or exercisable.

The fact that a transaction is entered into between such related enterprises does not, in and of itself, mean that a Contracting State may adjust the income (or loss) of one or both of the enterprises under the provisions of this Article. If the conditions of the transaction are consistent with those that would be made between independent persons, the income arising from that transaction should not be subject to adjustment under this Article.

Similarly, the fact that associated enterprises may have concluded arrangements, such as cost sharing arrangements or general services agreements, is not in itself an indication that the two enterprises have entered into a non-arm's-length transaction that should give rise to an adjustment under paragraph 1. Both related and unrelated parties enter into such arrangements (e.g., joint venturers may share some development costs). As with any other kind of transaction, when related parties enter into an arrangement, the specific arrangement must be examined to see whether or not it meets the arm's-length standard. In the event that it does not, an appropriate adjustment may be made, which may include modifying the terms of the agreement or re-characterizing the transaction to reflect its substance.

It is understood that the "commensurate with income" standard for determining appropriate transfer prices for intangibles, added to Code section 482 by the Tax Reform Act of 1986, was designed to operate consistently with the arm's-length standard. The implementation of this standard in the section 482 regulations is in accordance with the general principles of paragraph 1 of Article 9 of the Convention, as interpreted by the OECD Transfer Pricing Guidelines.

This Article also permits tax authorities to deal with thin capitalization issues. They may, in the context of Article 9, scrutinize more than the rate of interest charged on a loan between related persons. They also may examine the capital structure of an enterprise, whether a payment in respect of that loan should be treated as interest, and, if it is treated as interest, under what circumstances interest deductions should be allowed to the payor. Paragraph 2 of the Commentary to Article 9 of the OECD Model, together with the U.S. observation set forth in paragraph 15, sets forth a similar understanding of the scope of Article 9 in the context of thin capitalization.

*Paragraph 2*

When a Contracting State has made an adjustment that is consistent with the provisions of paragraph 1, and the other Contracting State agrees that the adjustment was appropriate to reflect arm's-length conditions, that other Contracting State is obligated to make a correlative adjustment (sometimes referred to as a "corresponding adjustment") to the tax liability of the related person in that other Contracting State. Although the OECD Model does not specify that the other Contracting State must agree with the initial adjustment before it is obligated to make the correlative adjustment, the Commentary makes clear that the paragraph is to be read that way.

As explained in the Commentary to Article 9 of the OECD Model, Article 9 leaves the treatment of "secondary adjustments" to the laws of the Contracting States. When an adjustment under Article 9 has been made, one of the parties will have in its possession funds that it would not have had at arm's length. The question arises as to how to treat these funds. In the United States the general practice is to treat such funds as a dividend or contribution to capital, depending on the relationship between the parties. Under certain circumstances, the parties may be permitted to restore the funds to the party that would have the funds had the transactions been entered into on arm's length terms, and to establish an account payable pending restoration of the funds. See Rev. Proc. 99-32, 1999-2 C.B. 296.

The Contracting State making a secondary adjustment will take the other provisions of the Convention, where relevant, into account. For example, if the effect of a secondary adjustment is to treat a U.S. corporation as having made a distribution of profits to its parent corporation in the other Contracting State, the provisions of Article 10 (Dividends) will apply, and the United States may impose a 5 percent withholding tax on the dividend. Also, if under Article 23 (Relief from Double Taxation) the other State generally gives a credit for taxes paid with respect to such dividends, it would also be required to do so in this case.

The competent authorities are authorized by paragraph 3 of Article 25 (Mutual Agreement Procedure) to consult, if necessary, to resolve any differences in the application of these provisions. For example, there may be a disagreement over whether an adjustment made by a Contracting State under paragraph 1 was appropriate.

If a correlative adjustment is made under paragraph 2, it is to be implemented, pursuant to paragraph 2 of Article 25 (Mutual Agreement Procedure), notwithstanding any time limits or other procedural limitations in the law of the Contracting State making the adjustment. If a taxpayer has entered a closing agreement (or other written settlement) with the United States prior to bringing a case to the competent authorities, the U.S. competent authority will endeavor only to obtain a correlative adjustment from Malta. See, Rev. Proc. 2006-54, 2006-49 I.R.B. 1035, Section 7.05.

*Relationship to Other Articles*

The saving clause of paragraph 4 of Article 1 (General Scope) does not apply to paragraph 2 of Article 9 by virtue of an exception to the saving clause in subparagraph 5(a) of Article 1. Thus, even

if the statute of limitations has run, a refund of tax can be made in order to implement a correlative adjustment. Statutory or procedural limitations, however, cannot be overridden to impose additional tax, because paragraph 2 of Article 1 provides that the Convention cannot restrict any statutory benefit.

#### ARTICLE 10 (DIVIDENDS)

Article 10 provides rules for the taxation of dividends paid by a company that is a resident of one Contracting State to a beneficial owner that is a resident of the other Contracting State. The Article provides for full residence-State taxation of such dividends and a limited source-State right to tax. Article 10 also provides rules for the imposition of a tax on branch profits by the State of source. Finally, the article prohibits a State from imposing taxes on a company resident in the other Contracting State, other than a branch profits tax, on undistributed earnings.

##### *Paragraph 1*

The right of a shareholder's country of residence to tax dividends arising in the source country is preserved by paragraph 1, which permits a Contracting State to tax its residents on dividends paid to them by a company that is a resident of the other Contracting State. For dividends from any other source paid to a resident, Article 21 (Other Income) grants the residence country exclusive taxing jurisdiction (other than for dividends attributable to a permanent establishment in the other State).

##### *Paragraph 2*

The State of source also may tax dividends beneficially owned by a resident of the other State, subject to the limitations of paragraphs 2 and 3. With respect to dividends paid by a company resident in the United States, paragraph 2(a) generally limits the rate of U.S. withholding tax to 15 percent of the gross amount of the dividend. If, however, the beneficial owner of the dividend is a company resident in Malta and owns directly shares representing at least 10 percent of the voting power of the company paying the dividend, then the rate of withholding tax in the United States is limited to 5 percent of the gross amount of the dividend. Shares are considered voting shares if they provide the power to elect, appoint or replace any person vested with the powers ordinarily exercised by the board of directors of a U.S. corporation. With respect to dividends paid by a company resident in Malta to a beneficial owner that is a resident of the United States, subparagraph 2(b) limits the tax that may be charged by Malta to the Maltese tax chargeable on the profits out of which the dividends are paid.

The benefits of paragraph 2 may be granted at the time of payment by means of reduced rate of withholding tax at source. It also is consistent with the paragraph for tax to be withheld at the time of payment at full statutory rates, and the treaty benefit to be granted by means of a subsequent refund so long as such procedures are applied in a reasonable manner.

The determination of whether the ownership threshold for subparagraph 2(a)(i) is met for purposes of the 5 percent maximum rate of withholding tax is made on the date on which entitlement

to the dividend is determined. Thus, the determination would generally be made on the dividend record date.

Paragraph 2 does not affect the taxation of the profits out of which the dividends are paid. The taxation by a Contracting State of the income of its resident companies is governed by the internal law of the Contracting State, subject to the provisions of paragraph 4 of Article 24 (Non-Discrimination).

The term “beneficial owner” is not defined in the Convention, and is, therefore, defined as under the internal law of the State granting treaty benefits (i.e., the source State). The beneficial owner of the dividend for purposes of Article 10 is the person to which the income is attributable under the laws of the source State. Thus, if a dividend paid by a corporation that is a resident of one of the States (as determined under Article 4 (Residence)) is received by a nominee or agent that is a resident of the other State on behalf of a person that is not a resident of that other State, the dividend is not entitled to the benefits of this Article. However, a dividend received by a nominee on behalf of a resident of that other State would be entitled to benefits. These limitations are confirmed by paragraph 12 of the Commentary to Article 10 of the OECD Model. See also paragraph 24 of the Commentary to Article 1 of the OECD Model.

Special rules, however, apply to shares that are held through fiscally transparent entities. In that case, the rules of paragraph 6 of Article 1 (General Scope) will apply to determine whether the dividends should be treated as having been derived by a resident of a Contracting State. Residence-State principles shall be used to determine who derives the dividend, to assure that the dividends for which the source State grants benefits of the Convention will be taken into account for tax purposes by a resident of the residence State. Source State principles of beneficial ownership shall then apply to determine whether the person who derives the dividends, or another resident of the other Contracting State, is the beneficial owner of the dividend. If the person who derives the dividend under paragraph 6 of Article 1 would not be treated a nominee, agent, custodian, conduit, etc. under the source State’s principles for determining beneficial ownership as, that person will be treated as the beneficial owner of the income, profits or gains for purposes of the Convention.

Assume for instance, that a company resident in Malta pays a dividend to LLC, an entity that is treated as fiscally transparent for U.S. tax purposes but is treated as a company for Maltese tax purposes. USCo, a company incorporated in the United States, is the sole interest holder in LLC. Paragraph 6 of Article 1 provides that USCo derives the dividend. Malta’s principles of beneficial ownership shall then be applied to USCo. If under the laws of Malta USCo is found not to be the beneficial owner of the dividend, USCo will not be entitled to the benefits of Article 10 with respect to such dividend. The payment may be entitled to benefits, however, if USCo is found to be a nominee, agent, custodian, or conduit for another person who is a resident of the United States.

Beyond identifying the person to whom the principles of beneficial ownership shall be applied, the principles of paragraph 6 of Article 1 will also apply when determining whether other require-

ments, such as the ownership threshold of subparagraph 2(a)(i) have been satisfied.

For example, assume that MCo, a company that is a resident of Malta, owns all of the outstanding shares in ThirdDE, an entity that is disregarded for U.S. tax purposes that is resident in a third country. ThirdDE owns 100% of the stock of USCo. Malta views ThirdDE as fiscally transparent under its domestic law, and taxes MCo currently on the income derived by ThirdDE. In this case, MCo is treated as deriving the dividends paid by USCo under paragraph 6 of Article 1. Moreover, MCo is treated as owning the shares of USCo directly. The Convention does not address what constitutes direct ownership for purposes of Article 10. As a result, whether ownership is direct is determined under the internal law of the State granting treaty benefits (i.e., the source State) unless the context otherwise requires. Accordingly, a company that holds stock through such an entity will generally be considered to directly own such stock for purposes of Article 10.

This result may change, however, if ThirdDE is regarded as non-fiscally transparent under the laws of Malta. Assuming that ThirdDE is treated as non-fiscally transparent by Malta, the income will not be treated as derived by a resident of Malta for purposes of the Convention. However, ThirdDE may still be entitled to the benefits of the U.S. tax treaty, if any, with its country of residence.

The same principles would apply in determining whether companies holding shares through fiscally transparent entities such as partnerships, trusts, and estates would qualify for benefits. As a result, companies holding shares through such entities may be able to claim the benefits of subparagraph (a)(i) under certain circumstances. The lower rate applies when the company's proportionate share of the shares held by the intermediate entity meets the 10 percent threshold, and the company meets the requirements of subparagraph 6 of Article 1 (i.e., the company's country of residence treats the intermediate entity as fiscally transparent) with respect to the dividend. Whether this ownership threshold is satisfied may be difficult to determine and often will require an analysis of the partnership or trust agreement.

### *Paragraph 3*

Paragraph 3 provides that dividends beneficially owned by a pension fund may not be taxed in the Contracting State of which the company paying the tax is a resident, unless such dividends are derived from the carrying on of a business, directly or indirectly, by the pension fund or through an associated enterprise. For these purposes, the term "pension fund" is defined in subparagraph 1(k) of Article 3 (General Definitions).

### *Paragraph 4*

Paragraph 4 imposes limitations on the rate reductions provided by paragraphs 2 and 3 in the case of dividends paid by RIC or a REIT.

The first sentence of subparagraph 4(a) provides that dividends paid by a RIC or REIT are not eligible for the 5 percent rate of withholding tax of subparagraph 2(a)(i).

The second sentence of subparagraph 4(a) provides that the 15 percent maximum rate of withholding tax of subparagraph 2(a)(ii) applies to dividends paid by RICs and that the elimination of source-country withholding tax of paragraph 3 applies to dividends paid by RICs and beneficially owned by a pension fund.

The third sentence of subparagraph 4(a) provides that the 15 percent rate of withholding tax also applies to dividends paid by a REIT and that the elimination of source-country withholding tax of paragraph 3 applies to dividends paid by REITs and beneficially owned by a pension fund, provided that one of the three following conditions is met. First, the beneficial owner of the dividend is an individual or a pension fund, in either case holding an interest of not more than 10 percent in the REIT. Second, the dividend is paid with respect to a class of stock that is publicly traded and the beneficial owner of the dividend is a person holding an interest of not more than 5 percent of any class of the REIT's shares. Third, the beneficial owner of the dividend holds an interest in the REIT of not more than 10 percent and the REIT is "diversified."

Subparagraph (b) provides a definition of the term "diversified." A REIT is diversified if the gross value of no single interest in real property held by the REIT exceeds 10 percent of the gross value of the REIT's total interest in real property. Foreclosure property is not considered an interest in real property, and a REIT holding a partnership interest is treated as owning its proportionate share of any interest in real property held by the partnership.

The restrictions set out above are intended to prevent the use of these entities to gain inappropriate U.S. tax benefits. For example, a company resident in Malta that wishes to hold a diversified portfolio of U.S. corporate shares could hold the portfolio directly and would bear a U.S. withholding tax of 15 percent on all of the dividends that it receives. Alternatively, it could hold the same diversified portfolio by purchasing 10 percent or more of the interests in a RIC that in turn held the portfolio. Absent the special rule in paragraph 4, such use of the RIC could transform portfolio dividends, taxable in the United States under the Convention at a 15 percent maximum rate of withholding tax, into direct investment dividends taxable at a 5 percent maximum rate of withholding tax or eligible for the elimination of source-country withholding tax on dividends paid to pension funds.

Similarly, a resident of Malta directly holding U.S. real property would pay U.S. tax upon the sale of the property either at a 30 percent rate of withholding tax on the gross income or at graduated rates on the net income. As in the preceding example, by placing the real property in a REIT, the investor could, absent a special rule, transform income from the sale of real estate into dividend income from the REIT, taxable at the rates provided in Article 10, significantly reducing the U.S. tax that otherwise would be imposed. Paragraph 4 prevents this result and thereby avoids a disparity between the taxation of direct real estate investments and real estate investments made through REITs. In the cases in which paragraph 4 allows a dividend from a REIT to be eligible for the 15 percent rate of withholding tax, the holding in the REIT is not considered the equivalent of a direct holding in the underlying real property.

*Paragraph 5*

Paragraph 5 defines the term dividends broadly and flexibly. The definition is intended to cover all arrangements that yield a return on an equity investment in a corporation as determined under the tax law of the state of source, as well as arrangements that might be developed in the future.

The term includes income from shares, or other corporate rights that are not treated as debt under the law of the source State, that participate in the profits of the company. The term also includes income that is subjected to the same tax treatment as income from shares by the law of the State of source. Thus, a constructive dividend that results from a non-arm's length transaction between a corporation and a related party is a dividend. In the case of the United States the term dividend includes amounts treated as a dividend under U.S. law upon the sale or redemption of shares or upon a transfer of shares in a reorganization. See, e.g., Rev. Rul. 92-85, 1992-2 C.B. 69 (sale of foreign subsidiary's stock to U.S. sister company is a deemed dividend to extent of the subsidiary's and sister company's earnings and profits). Further, a distribution from a U.S. publicly traded limited partnership, which is taxed as a corporation under U.S. law, is a dividend for purposes of Article 10. However, a distribution by a limited liability company is not taxable by the United States under Article 10, provided the limited liability company is not characterized as an association taxable as a corporation under U.S. law.

Finally, a payment denominated as interest that is made by a thinly capitalized corporation may be treated as a dividend to the extent that the debt is recharacterized as equity under the laws of the source State.

*Paragraph 6*

Paragraph 6 provides a rule for taxing dividends paid with respect to holdings that form part of the business property of a permanent establishment. In such case, the rules of Article 7 (Business Profits) shall apply. Accordingly, the dividends will be taxed on a net basis using the rates and rules of taxation generally applicable to residents of the State in which the permanent establishment is located, as such rules may be modified by the Convention. An example of dividends paid with respect to the business property of a permanent establishment would be dividends derived by a dealer in stock or securities from stock or securities that the dealer held for sale to customers.

*Paragraph 7*

The right of a Contracting State to tax dividends paid by a company that is a resident of the other Contracting State is restricted by paragraph 7 to cases in which the dividends are paid to a resident of that Contracting State or are attributable to a permanent establishment or fixed base in that Contracting State. Thus, a Contracting State may not impose a "secondary" withholding tax on dividends paid by a nonresident company out of earnings and profits from that Contracting State.

The paragraph also restricts the right of a Contracting State to impose corporate level taxes on undistributed profits, other than a



branch profits tax. The paragraph does not restrict a State's right to tax its resident shareholders on undistributed earnings of a corporation resident in the other State. Thus, the authority of the United States to impose taxes on subpart F income and on earnings deemed invested in U.S. property, and its tax on income of a passive foreign investment company that is a qualified electing fund is in no way restricted by this provision.

*Paragraph 8*

Paragraph 8 permits a Contracting State to impose a branch profits tax on a company resident in the other Contracting State. The tax is in addition to other taxes permitted by the Convention. The term "company" is defined in subparagraph 1(b) of Article 3 (General Definitions).

A Contracting State may impose a branch profits tax on a company if the company has income attributable to a permanent establishment in that Contracting State, derives income from real (immovable) property in that Contracting State that is taxed on a net basis under Article 6 (Income from Real (Immovable) Property), or realizes gains taxable in that State under paragraph 1 of Article 13 (Gains). In the case of the United States, the imposition of such tax is limited, however, to the portion of the aforementioned items of income that represents the amount of such income that is the "dividend equivalent amount." This is consistent with the relevant rules under the U.S. branch profits tax, and the term dividend equivalent amount is defined under U.S. law. Section 884 defines the dividend equivalent amount as an amount for a particular year that is equivalent to the income described above that is included in the corporation's effectively connected earnings and profits for that year, after payment of the corporate tax under Articles 6 (Income from Real (Immovable) Property), 7 (Business Profits) or 13 (Gains), reduced for any increase in the branch's U.S. net equity during the year or increased for any reduction in its U.S. net equity during the year. U.S. net equity is U.S. assets less U.S. liabilities. See Treas. Reg. section 1.884-1.

The dividend equivalent amount for any year approximates the dividend that a U.S. branch office would have paid during the year if the branch had been operated as a separate U.S. subsidiary company. If Malta also imposes a branch profits tax, the base of its tax must be limited to an amount that is analogous to the dividend equivalent amount.

As discussed in the explanation of paragraph 2 of Article 1 (General Scope), consistency principles prohibit a taxpayer from applying provisions of the Code and this Convention inconsistently. In the context of the branch profits tax, this consistency requirement means that if a Maltese company uses the principles of Article 7 to determine its U.S. taxable income then it must also use those principles to determine its dividend equivalent amount. Similarly, if the Maltese company instead uses the Code to determine its U.S. taxable income it must also use the Code to determine its dividend equivalent amount. As in the case of Article 7, if a Maltese company, for example, does not from year to year consistently apply the Code or the Convention to determine its dividend equivalent amount, then the Maltese company must make appropriate adjust-

ments or recapture amounts that would otherwise be subject to U.S. branch profits tax if it had consistently applied the Code or the Convention to determine its dividend equivalent amount from year to year.

Subparagraph (b) provides that the branch profits tax shall not be imposed at a rate exceeding five percent. It is intended that subparagraph (b) apply equally if a taxpayer determines its taxable income under the laws of a Contracting State or under the provisions of Article 7. For example, as discussed above, consistency principles require a Maltese company that determines its U.S. taxable income under the Code to also determine its dividend equivalent amount under the Code. In that case, subparagraph (b) would apply even though the Maltese company did not determine its dividend equivalent amount using the principles of Article 7.

#### *Relationship to Other Articles*

Notwithstanding the foregoing limitations on source country taxation of dividends, the saving clause of paragraph 4 of Article 1 permits the United States to tax dividends received by its residents and citizens, subject to the special foreign tax credit rules of paragraph 4 of Article 23 (Relief from Double Taxation), as if the Convention had not come into effect.

The benefits of this Article are also subject to the provisions of Article 22 (Limitation on Benefits). Thus, if a resident of the other Contracting State is the beneficial owner of dividends paid by a U.S. corporation, the shareholder must qualify for treaty benefits under at least one of the tests of Article 22 in order to receive the benefits of this Article.

### ARTICLE 11 (INTEREST)

Article 11 provides rules for the taxation of interest arising in one Contracting State and paid to a beneficial owner that is a resident of the other Contracting State.

#### *Paragraph 1*

Paragraph 1 grants to the State of residence the non-exclusive right to tax interest beneficially owned by its residents and arising in the other Contracting State.

The term “beneficial owner” is not defined in the Convention, and is, therefore, defined under the internal law of the State granting treaty benefits (i.e., the source State). The beneficial owner of the interest for purposes of Article 11 is the person to which the income is attributable under the laws of the source State. Thus, if interest arising in a Contracting State is received by a nominee or agent that is a resident of the other State on behalf of a person that is not a resident of that other State, the interest is not entitled to the benefits of Article 11. However, interest received by a nominee on behalf of a resident of that other State would be entitled to benefits. These limitations are confirmed by paragraph 9 of the OECD Commentary to Article 11.

#### *Paragraph 2*

Paragraph 2 provides that the State of source also may tax interest beneficially owned by a resident of the other Contracting State,

but the rate of tax shall be limited to 10 percent of the gross amount of the interest.

*Paragraph 3*

Paragraph 3 provides anti-abuse exceptions to paragraphs 1 and 2 for two classes of interest payments.

The first class of interest, dealt with in subparagraph (a) is U.S.-source contingent interest of a type that does not qualify as portfolio interest under U.S. domestic law. The cross-reference to the U.S. definition of contingent interest, which is found in section 871(h)(4) of the Code, is intended to ensure that the exceptions of section 871(h)(4)(c) will be applicable. Any such interest may be taxed in the United States according to U.S. domestic law. If the beneficial owner is a resident of Malta, however, the gross amount of the interest may be taxed at a rate not exceeding 15 percent.

The second class of interest is dealt with in subparagraph c) of paragraph 2. This exception is consistent with the policy of Code sections 860E(e) and 860G(b) that excess inclusions with respect to a real estate mortgage investment conduit (REMIC) should bear full U.S. tax in all cases. Without a full tax at source foreign purchasers of residual interests would have a competitive advantage over U.S. purchasers at the time these interests are initially offered. Also, absent this rule, the U.S. fisc would suffer a revenue loss with respect to mortgages held in a REMIC because of opportunities for tax avoidance created by differences in the timing of taxable and economic income produced by these interests.

*Paragraph 4*

The term “interest” as used in Article 11 is defined in paragraph 4 to include, inter alia, income from debt claims of every kind, whether or not secured by a mortgage. Penalty charges for late payment are excluded from the definition of interest. Interest that is paid or accrued subject to a contingency is within the ambit of Article 11. This includes income from a debt obligation carrying the right to participate in profits. The term does not, however, include amounts that are treated as dividends under Article 10 (Dividends).

The term interest also includes amounts subject to the same tax treatment as income from money lent under the law of the State in which the income arises. Thus, for purposes of the Convention, amounts that the United States will treat as interest include (i) the difference between the issue price and the stated redemption price at maturity of a debt instrument (i.e., original issue discount (“OID”)), which may be wholly or partially realized on the disposition of a debt instrument (section 1273), (ii) amounts that are imputed interest on a deferred sales contract (section 483), (iii) amounts treated as interest or OID under the stripped bond rules (section 1286), (iv) amounts treated as original issue discount under the below-market interest rate rules (section 7872), (v) a partner’s distributive share of a partnership’s interest income (section 702), (vi) the interest portion of periodic payments made under a “finance lease” or similar contractual arrangement that in substance is a borrowing by the nominal lessee to finance the acquisition of property, (vii) amounts included in the income of a holder

of a residual interest in a REMIC (section 860E), because these amounts generally are subject to the same taxation treatment as interest under U.S. tax law, and (viii) interest with respect to notional principal contracts that are re-characterized as loans because of a “substantial non-periodic payment.”

*Paragraph 5*

Paragraph 5 provides a rule for taxing interest in cases where the beneficial owner of the interest carries on business through a permanent establishment in the State of source situated in that State and the interest is attributable to that permanent establishment. In such cases the provisions of Article 7 (Business Profits) will apply and the State of source will retain the right to impose tax on such interest income.

In the case of a permanent establishment that once existed in the State of source but that no longer exists, the provisions of paragraph 5 also apply, by virtue of paragraph 7 of Article 7, to interest that would be attributable to such a permanent establishment or fixed base if it did exist in the year of payment or accrual. See the Technical Explanation of paragraph 7 of Article 7.

*Paragraph 6*

Paragraph 6 provides a source rule for interest that is identical in substance to the interest source rule of the OECD Model. Interest is considered to arise in a Contracting State if paid by a resident of that State. As an exception, interest on a debt incurred in connection with a permanent establishment in one of the States and borne by the permanent establishment is deemed to arise in that State. For this purpose, interest is considered to be borne by a permanent establishment if it is allocable to taxable income of that permanent establishment.

*Paragraph 7*

Paragraph 7 provides that in cases involving special relationships between the payor and the beneficial owner of interest income, Article 11 applies only to that portion of the total interest payments that would have been made absent such special relationships (i.e., an arm’s-length interest payment). Any excess amount of interest paid remains taxable according to the laws of the United States and Malta, respectively, with due regard to the other provisions of the Convention. Thus, if the excess amount would be treated under the source country’s law as a distribution of profits by a corporation, such amount could be taxed as a dividend rather than as interest, but the tax would be subject, if appropriate, to the rate limitations of paragraph 2 of Article 10 (Dividends).

The term “special relationship” is not defined in the Convention. In applying this paragraph the United States considers the term to include the relationships described in Article 9, which in turn corresponds to the definition of “control” for purposes of section 482 of the Code.

This paragraph does not address cases where, owing to a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest is less than an arm’s-length amount. In those cases a transaction may

be characterized to reflect its substance and interest may be imputed consistent with the definition of interest in paragraph 4. The United States would apply section 482 or 7872 of the Code to determine the amount of imputed interest in those cases.

*Paragraph 8*

Paragraph 8 permits the United States to impose its branch level interest tax on a corporation resident in Malta. The base of this tax is the excess, if any, of the interest deductible in the United States in computing the profits of the corporation that are subject to tax in the United States and either attributable to a permanent establishment in the United States or subject to tax in the United States under Article 6 (Income from Real Property) or paragraph 1 of Article 13 (Alienation of Property) of the Convention over the interest paid by the permanent establishment or trade or business in the United States. Such excess interest may be taxed as if it were interest arising in the United States and beneficially owned by the corporation resident in Malta. Thus, such excess interest may be taxed by the United States at a rate not to exceed the 10 percent rate provided for in paragraph 2.

*Relationship to Other Articles*

Notwithstanding the foregoing limitations on source country taxation of interest, the saving clause of paragraph 4 of Article 1 permits the United States to tax its residents and citizens, subject to the special foreign tax credit rules of paragraph 4 of Article 23 (Relief from Double Taxation), as if the Convention had not come into force.

As with other benefits of the Convention, the benefits of Article 11 are available to a resident of the other State only if that resident is entitled to those benefits under the provisions of Article 22 (Limitation on Benefits).

ARTICLE 12 (ROYALTIES)

Article 12 provides rules for the taxation of royalties arising in one Contracting State and paid to a beneficial owner that is a resident of the other Contracting State.

*Paragraph 1*

Paragraph 1 grants to the State of residence the non-exclusive right to tax royalties beneficially owned by its residents and arising in the other Contracting State.

The term “beneficial owner” is not defined in the Convention, and is, therefore, defined under the internal law of the State granting treaty benefits (i.e., the source State). The beneficial owner of the royalty for purposes of Article 12 is the person to which the income is attributable under the laws of the source State. Thus, if a royalty arising in a Contracting State is received by a nominee or agent that is a resident of the other State on behalf of a person that is not a resident of that other State, the royalty is not entitled to the benefits of Article 12. However, a royalty received by a nominee on behalf of a resident of that other State would be entitled to benefits. These limitations are confirmed by paragraph 4 of the OECD Commentary to Article 12.

*Paragraph 2*

Paragraph 2 provides that the State of source also may tax royalties beneficially owned by a resident of the other Contracting State, but the rate of tax shall be limited to 10 percent of the gross amount of the royalties.

*Paragraph 3*

Paragraph 3 defines the term “royalties,” as used in Article 12, to include any consideration for the use of, or the right to use, any copyright of literary, artistic, scientific or other work (such as cinematographic films), any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial, or scientific experience. The term “royalties” also includes gain derived from the alienation of any right or property that would give rise to royalties, to the extent the gain is contingent on the productivity, use, or further alienation thereof. Gains that are not so contingent are dealt with under Article 13 (Gains). The term “royalties,” however, does not include income from leasing personal property.

The term royalties is defined in the Convention and therefore is generally independent of domestic law. Certain terms used in the definition are not defined in the Convention, but these may be defined under domestic tax law. For example, the term “secret process or formulas” is found in the Code, and its meaning has been elaborated in the context of sections 351 and 367. See Rev. Rul. 55-17, 1955-1 C.B. 388; Rev. Rul. 64-56, 1964-1 C.B. 133; Rev. Proc. 69-19, 1969-2 C.B. 301.

Consideration for the use or right to use cinematographic films, or works on film, tape, or other means of reproduction in radio or television broadcasting is specifically included in the definition of royalties. It is intended that, with respect to any subsequent technological advances in the field of radio or television broadcasting, consideration received for the use of such technology will also be included in the definition of royalties.

If an artist who is resident in one Contracting State records a performance in the other Contracting State, retains a copyrighted interest in a recording, and receives payments for the right to use the recording based on the sale or public playing of the recording, then the right of such other Contracting State to tax those payments is governed by Article 12. See *Boulez v. Commissioner*, 83 T.C. 584 (1984), *affd*, 810 F.2d 209 (D.C. Cir. 1986). By contrast, if the artist earns in the other Contracting State income covered by Article 16 (Entertainers and Sportsmen), for example, endorsement income from the artist’s attendance at a film screening, and if such income also is attributable to one of the rights described in Article 12 (e.g., the use of the artist’s photograph in promoting the screening), Article 16 and not Article 12 is applicable to such income.

Computer software generally is protected by copyright laws around the world. Under the Convention, consideration received for the use, or the right to use, computer software is treated either as royalties or as business profits, depending on the facts and circumstances of the transaction giving rise to the payment.

The primary factor in determining whether consideration received for the use, or the right to use, computer software is treated as royalties or as business profits is the nature of the rights transferred. See Treas. Reg. section 1.861-18. The fact that the transaction is characterized as a license for copyright law purposes is not dispositive. For example, a typical retail sale of “shrink wrap” software generally will not be considered to give rise to royalty income, even though for copyright law purposes it may be characterized as a license.

The means by which the computer software is transferred are not relevant for purposes of the analysis. Consequently, if software is electronically transferred but the rights obtained by the transferee are substantially equivalent to rights in a program copy, the payment will be considered business profits.

The term “industrial, commercial, or scientific experience” (sometimes referred to as “know-how”) has the meaning ascribed to it in paragraph 11 et seq. of the Commentary to Article 12 of the OECD Model. Consistent with that meaning, the term may include information that is ancillary to a right otherwise giving rise to royalties, such as a patent or secret process.

Know-how also may include, in limited cases, technical information that is conveyed through technical or consultancy services. It does not include general educational training of the user’s employees, nor does it include information developed especially for the user, such as a technical plan or design developed according to the user’s specifications. Thus, as provided in paragraph 11.3 of the Commentary to Article 12 of the OECD Model, the term “royalties” does not include payments received as consideration for after-sales service, for services rendered by a seller to a purchaser under a warranty, or for pure technical assistance.

The term “royalties” also does not include payments for professional services (such as architectural, engineering, legal, managerial, medical, software development services). For example, income from the design of a refinery by an engineer (even if the engineer employed know-how in the process of rendering the design) or the production of a legal brief by a lawyer is not income from the transfer of know-how taxable under Article 12, but is income from services taxable under either Article 7 (Business Profits) or Article 14 (Income from Employment). Professional services may be embodied in property that gives rise to royalties, however. Thus, if a professional contracts to develop patentable property and retains rights in the resulting property under the development contract, subsequent license payments made for those rights would be royalties.

#### *Paragraph 4*

This paragraph provides a rule for taxing royalties in cases where the beneficial owner of the royalties carries on business through a permanent establishment in the state of source and the royalties are attributable to that permanent establishment. In such cases the provisions of Article 7 will apply.

The provisions of paragraph 7 of Article 7 apply to this paragraph. For example, royalty income that is attributable to a permanent establishment and that accrues during the existence of the permanent establishment, but is received after the permanent es-

establishment no longer exists, remains taxable under the provisions of Article 7, and not under this Article.

*Paragraph 5*

Paragraph 5 contains the source rule for royalties. Under paragraph 5, royalties are treated as arising in a Contracting State when they are in consideration for the use of, or the right to use, property, information or experience in that State. This source rule parallels the source rule in section 861(a)(4) of the Code.

*Paragraph 6*

Paragraph 6 provides that in cases involving special relationships between the payor and beneficial owner of royalties, Article 12 applies only to the extent the royalties would have been paid absent such special relationships (i.e., an arm's-length royalty). Any excess amount of royalties paid remains taxable according to the laws of the two Contracting States, with due regard to the other provisions of the Convention. If, for example, the excess amount is treated as a distribution of corporate profits under domestic law, such excess amount will be taxed as a dividend rather than as royalties, but the tax imposed on the dividend payment will be subject to the rate limitations of paragraph 2 of Article 10 (Dividends).

*Relationship to Other Articles*

Notwithstanding the foregoing limitations on source country taxation of royalties, the saving clause of paragraph 4 of Article 1 (General Scope) permits the United States to tax its residents and citizens, subject to the special foreign tax credit rules of paragraph 4 of Article 23 (Relief from Double Taxation), as if the Convention had not come into force.

As with other benefits of the Convention, the benefits of Article 12 are available to a resident of the other State only if that resident is entitled to those benefits under Article 22 (Limitation on Benefits).

ARTICLE 13 (GAINS)

Article 13 assigns either primary or exclusive taxing jurisdiction over gains from the alienation of property to the State of residence or the State of source.

*Paragraph 1*

Paragraph 1 of Article 13 preserves the non-exclusive right of the State of source to tax gains attributable to the alienation of real property situated in that State. The paragraph therefore permits the United States to apply section 897 of the Code to tax gains derived by a resident of Malta that are attributable to the alienation of real property situated in the United States (as defined in paragraph 2). Gains attributable to the alienation of real property include gains from any other property that is treated as a real property interest within the meaning of paragraph 2.

Paragraph 1 refers to gains "attributable to the alienation of real (immovable) property" rather than the OECD Model phrase "gains from the alienation" to clarify that the United States will look



through distributions made by a REIT and certain RICs. Accordingly, distributions made by a REIT or certain RICs are taxable under paragraph 1 of Article 13 (not under Article 10 (Dividends)) when they are attributable to gains derived from the alienation of real property.

*Paragraph 2*

This paragraph defines the term “real (immovable) property situated in the other Contracting State.” The term includes real (immovable) property referred to in Article 6 (i.e., an interest in the real (immovable) property itself), a “United States real property interest” (when the United States is the other Contracting State under paragraph 1), and an equivalent interest in real (immovable) property situated in Malta (when Malta is the other Contracting State under paragraph 1).

Under section 897(c) of the Code the term “United States real property interest” includes shares in a U.S. corporation that owns sufficient U.S. real property interests to satisfy an asset-ratio test on certain testing dates. The term also includes certain foreign corporations that have elected to be treated as U.S. corporations for this purpose. Section 897(i).

*Paragraph 3*

Paragraph 3 of Article 13 deals with the taxation of certain gains from the alienation of movable property forming part of the business property of a permanent establishment that an enterprise of a Contracting State has in the other Contracting State. This also includes gains from the alienation of such a permanent establishment (alone or with the whole enterprise). Such gains may be taxed in the State in which the permanent establishment is located.

A resident of Malta that is a partner in a partnership doing business in the United States generally will have a permanent establishment in the United States as a result of the activities of the partnership, assuming that the activities of the partnership rise to the level of a permanent establishment. Rev. Rul. 91-32, 1991-1 C.B. 107. Further, under paragraph 3, the United States generally may tax a partner’s distributive share of income realized by a partnership on the disposition of movable property forming part of the business property of the partnership in the United States.

The gains subject to paragraph 3 may be taxed in the State in which the permanent establishment is located, regardless of whether the permanent establishment exists at the time of the alienation. This rule incorporates the rule of section 864(c)(6) of the Code. Accordingly, income that is attributable to a permanent establishment, but that is deferred and received after the permanent establishment no longer exists, may nevertheless be taxed by the State in which the permanent establishment was located.

*Paragraph 4*

This paragraph limits the taxing jurisdiction of the State of source with respect to gains from the alienation of ships or aircraft operated in international traffic by the enterprise alienating the ship or aircraft and from property (other than real (immovable)

property) pertaining to the operation or use of such ships, aircraft, or containers.

Under paragraph 4, such income is taxable only in the Contracting State in which the alienator is resident. Notwithstanding paragraph 3, the rules of this paragraph apply even if the income is attributable to a permanent establishment maintained by the enterprise in the other Contracting State. This result is consistent with the allocation of taxing rights under Article 8 (Shipping and Air Transport).

#### *Paragraph 5*

Paragraph 5 provides a rule similar to paragraph 4 with respect to gains from the alienation of containers and related personal property. Such gains derived by an enterprise of a Contracting State shall be taxable only in that Contracting State unless the containers were used for the transport of goods or merchandise solely within the other Contracting State. The other Contracting State may not tax the gain, even if the gain is attributable to a permanent establishment maintained by the enterprise in that other Contracting State.

#### *Paragraph 6*

Paragraph 6 grants to the State of residence of the alienator the exclusive right to tax gains from the alienation of property other than property referred to in paragraphs 1 through 5. For example, gain derived from shares, other than shares described in paragraphs 2 or 3, debt instruments and various financial instruments, may be taxed only in the State of residence, to the extent such income is not otherwise characterized as income taxable under another article (e.g., Article 10 (Dividends) or Article 11 (Interest)). Similarly gain derived from the alienation of tangible personal property, other than tangible personal property described in paragraph 3, may be taxed only in the State of residence of the alienator.

Gain derived from the alienation of any property, such as a patent or copyright, that produces income covered by Article 12 (Royalties) is governed by the rules of Article 12 and not by this article, provided that such gain is of the type described in paragraph 3(b) of Article 12 (i.e., it is contingent on the productivity, use, or disposition of the property).

Gains derived by a resident of a Contracting State from real (immovable) property located in a third state are not taxable in the other Contracting State, even if the sale is attributable to a permanent establishment located in the other Contracting State.

#### *Relationship to Other Articles*

Notwithstanding the foregoing limitations on taxation of certain gains by the State of source, the saving clause of paragraph 4 of Article 1 (General Scope) permits the United States to tax its citizens and residents as if the Convention had not come into effect. Thus, any limitation in this Article on the right of the United States to tax gains does not apply to gains of a U.S. citizen or resident.

The benefits of this Article are also subject to the provisions of Article 22 (Limitation on Benefits). Thus, only a resident of a Contracting State that satisfies one of the conditions in Article 22 is entitled to the benefits of this Article.

ARTICLE 14 (INCOME FROM EMPLOYMENT)

Article 14 apportions taxing jurisdiction over remuneration derived by a resident of a Contracting State as an employee between the States of source and residence.

*Paragraph 1*

The general rule of Article 14 is contained in paragraph 1. Remuneration derived by a resident of a Contracting State as an employee may be taxed by the State of residence, and the remuneration also may be taxed by the other Contracting State to the extent derived from employment exercised (i.e., services performed) in that other Contracting State. Paragraph 1 also provides that the more specific rules of Articles 15 (Directors' Fees), 17 (Pensions, Social Security, Annuities, Alimony and Child Support), and 19 (Government Service) apply in the case of employment income described in one of those articles. Thus, even though the State of source has a right to tax employment income under Article 14, it may not have the right to tax that income under the Convention if the income is described, for example, in Article 17 and is not taxable in the State of source under the provisions of that article.

Article 14 applies to any form of compensation for employment, including payments in kind. Paragraph 1.1 of the Commentary to Article 16 of the OECD Model confirms that interpretation.

Consistent with section 864(c)(6) of the Code, Article 14 also applies regardless of the timing of actual payment for services. Consequently, a person who receives the right to a future payment in consideration for services rendered in a Contracting State would be taxable in that State even if the payment is received at a time when the recipient is a resident of the other Contracting State. Thus, a bonus paid to a resident of a Contracting State with respect to services performed in the other Contracting State with respect to a particular taxable year would be subject to Article 14 for that year even if it was paid after the close of the year. An annuity received for services performed in a taxable year could be subject to Article 14 despite the fact that it was paid in subsequent years. In that case, it would be necessary to determine whether the payment constitutes deferred compensation, taxable under Article 14, or a qualified pension subject to the rules of Article 17. Article 14 also applies to income derived from the exercise of stock options granted with respect to services performed in the host State, even if those stock options are exercised after the employee has left the source country. If Article 14 is found to apply, whether such payments were taxable in the State where the employment was exercised would depend on whether the tests of paragraph 2 were satisfied in the year in which the services to which the payment relates were performed.

*Paragraph 2*

Paragraph 2 sets forth an exception to the general rule that employment income may be taxed in the State where it is exercised. Under paragraph 2, the State where the employment is exercised may not tax the income from the employment if three conditions are satisfied: (a) the individual is present in the other Contracting State for a period or periods not exceeding 183 days in any 12-month period that begins or ends during the relevant taxable year (i.e., in the United States, the calendar year in which the services are performed); (b) the remuneration is paid by, or on behalf of an employer who is not a resident of that other Contracting State; and (c) the remuneration is not borne as a deductible expense by a permanent establishment that the employer has in that other State. In order for the remuneration to be exempt from tax in the source State, all three conditions must be satisfied. This exception is identical to that set forth in the OECD Model.

The 183-day period in condition (a) is to be measured using the “days of physical presence” method. Under this method, the days that are counted include any day in which a part of the day is spent in the host country. (Rev. Rul. 56–24, 1956–1 C.B. 851.) Thus, days that are counted include the days of arrival and departure; weekends and holidays on which the employee does not work but is present within the country; vacation days spent in the country before, during or after the employment period, unless the individual’s presence before or after the employment can be shown to be independent of his presence there for employment purposes; and time during periods of sickness, training periods, strikes, etc., when the individual is present but not working. If illness prevented the individual from leaving the country in sufficient time to qualify for the benefit, those days will not count. Also, any part of a day spent in the host country while in transit between two points outside the host country is not counted. If the individual is a resident of the host country for part of the taxable year concerned and a non-resident for the remainder of the year, the individual’s days of presence as a resident do not count for purposes of determining whether the 183-day period is exceeded.

Conditions (b) and (c) are intended to ensure that a Contracting State will not be required to allow a deduction to the payor for compensation paid and at the same time to exempt the employee on the amount received. Accordingly, if a foreign person pays the salary of an employee who is employed in the host State, but a host State corporation or permanent establishment reimburses the payor with a payment that can be identified as a reimbursement, neither condition (b) nor (c), as the case may be, will be considered to have been fulfilled.

The reference to remuneration “borne by” a permanent establishment is understood to encompass all expenses that economically are incurred and not merely expenses that are currently deductible for tax purposes. Accordingly, the expenses referred to include expenses that are capitalizable as well as those that are currently deductible. Further, salaries paid by residents that are exempt from income taxation may be considered to be borne by a permanent establishment notwithstanding the fact that the expenses will be nei-

ther deductible nor capitalizable since the payor is exempt from tax.

*Paragraph 3*

Paragraph 3 contains a special rule applicable to remuneration for services performed by a resident of a Contracting State as an employee aboard a ship or aircraft operated in international traffic. Such remuneration may be taxed only in the State of residence of the employee if the services are performed as a member of the regular complement of the ship or aircraft. The “regular complement” includes the crew. In the case of a cruise ship, for example, it may also include others, such as entertainers, lecturers, etc., employed by the shipping company to serve on the ship throughout its voyage. The use of the term “regular complement” is intended to clarify that a person who exercises his employment as, for example, an insurance salesman while aboard a ship or aircraft is not covered by this paragraph.

If a U.S. citizen who is resident in Malta performs services as an employee in the United States and meets the conditions of paragraph 2 for source country exemption, he nevertheless is taxable in the United States by virtue of the saving clause of paragraph 4 of Article 1 (General Scope), subject to the special foreign tax credit rule of paragraph 4 of Article 23 (Relief from Double Taxation).

ARTICLE 15 (DIRECTORS’ FEES)

This Article provides that a Contracting State may tax the fees and other compensation paid by a company that is a resident of that State for services performed in that State by a resident of the other Contracting State in his capacity as a director of the company. This rule is an exception to the more general rules of Articles 7 (Business Profits) and 14 (Income from Employment). Thus, for example, in determining whether a director’s fee paid to a non-employee director is subject to tax in the country of residence of the corporation, it is not relevant to establish whether the fee is attributable to a permanent establishment in that State.

This Article is subject to the saving clause of paragraph 4 of Article 1 (General Scope). Thus, if a U.S. citizen who is a resident of Malta is a director of a U.S. corporation, the United States may tax his full remuneration regardless of where he performs his services.

ARTICLE 16 (ENTERTAINERS AND SPORTSMEN)

This Article deals with the taxation in a Contracting State of entertainers and sportsmen resident in the other Contracting State from the performance of their services as such. The Article applies both to the income of an entertainer or sportsman who performs services on his own behalf and one who performs services on behalf of another person, either as an employee of that person, or pursuant to any other arrangement. The rules of this Article take precedence, in some circumstances, over those of Articles 7 (Business Profits) and 14 (Income from Employment).

This Article applies only with respect to the income of entertainers and sportsmen. Others involved in a performance or athletic event, such as producers, directors, technicians, managers, coaches, etc., remain subject to the provisions of Articles 7 and 14.

In addition, except as provided in paragraph 2, income earned by juridical persons is not covered by Article 16.

*Paragraph 1*

Paragraph 1 describes the circumstances in which a Contracting State may tax the performance income of an entertainer or sportsman who is a resident of the other Contracting State. Under the paragraph, income derived by an individual resident of a Contracting State from activities as an entertainer or sportsman exercised in the other Contracting State may be taxed in that other State if the amount of the gross receipts derived by the performer exceeds \$20,000 (or its equivalent in Euros) for the taxable year. The \$20,000 includes expenses reimbursed to the individual or borne on his behalf. If the gross receipts exceed \$20,000, the full amount, not just the excess, may be taxed in the State of performance.

The Convention introduces this monetary threshold to distinguish between two groups of entertainers and athletes—those who are paid relatively large sums of money for very short periods of service, and who would, therefore, normally be exempt from host country tax under the standard personal services income rules, and those who earn relatively modest amounts and are, therefore, not easily distinguishable from those who earn other types of personal service income.

Tax may be imposed under paragraph 1 even if the performer would have been exempt from tax under Article 7 or 14. On the other hand, if the performer would be exempt from host-country tax under Article 16, but would be taxable under either Article 7 or 14, tax may be imposed under either of those Articles. Thus, for example, if a performer derives remuneration from his activities in an independent capacity, and the performer does not have a permanent establishment in the host State, he may be taxed by the host State in accordance with Article 16 if his remuneration exceeds \$20,000 annually, despite the fact that he generally would be exempt from host State taxation under Article 7. However, a performer who receives less than the \$20,000 threshold amount and therefore is not taxable under Article 16 nevertheless may be subject to tax in the host country under Article 7 or 14 if the tests for host-country taxability under the relevant Article are met. For example, if an entertainer who is an independent contractor earns \$14,000 of income in a State for the calendar year, but the income is attributable to his permanent establishment in the State of performance, that State may tax his income under Article 7.

Since it frequently is not possible to know until year-end whether the income an entertainer or sportsman derived from performances in a Contracting State will exceed \$20,000, nothing in the Convention precludes that Contracting State from withholding tax during the year and refunding it after the close of the year if the taxability threshold has not been met.

As explained in paragraph 9 of the Commentary to Article 17 of the OECD Model, Article 16 of the Convention applies to all income connected with a performance by the entertainer, such as appearance fees, award or prize money, and a share of the gate receipts. Income derived from a Contracting State by a performer who is a

resident of the other Contracting State from other than actual performance, such as royalties from record sales and payments for product endorsements, is not covered by this Article, but by other articles of the Convention, such as Article 12 (Royalties) or Article 7. For example, if an entertainer receives royalty income from the sale of live recordings, the royalty income would be subject to the provisions of Article 12, even if the performance was conducted in the source country, although the entertainer could be taxed in the source country with respect to income from the performance itself under Article 16 if the dollar threshold is exceeded.

In determining whether income falls under Article 16 or another article, the controlling factor will be whether the income in question is predominantly attributable to the performance itself or to other activities or property rights. For instance, a fee paid to a performer for endorsement of a performance in which the performer will participate would be considered to be so closely associated with the performance itself that it normally would fall within Article 16. Similarly, a sponsorship fee paid by a business in return for the right to attach its name to the performance would be so closely associated with the performance that it would fall under Article 16 as well. As indicated in paragraph 9 of the Commentary to Article 17 of the OECD Model, however, a cancellation fee would not be considered to fall within Article 16 but would be dealt with under Article 7 or 14.

As indicated in paragraph 4 of the Commentary to Article 17 of the OECD Model, where an individual fulfills a dual role as performer and non-performer (such as a player-coach or an actor-director), but his role in one of the two capacities is negligible, the predominant character of the individual's activities should control the characterization of those activities. In other cases there should be an apportionment between the performance-related compensation and other compensation.

Consistent with Article 14, Article 16 also applies regardless of the timing of actual payment for services. Thus, a bonus paid to a resident of a Contracting State with respect to a performance in the other Contracting State during a particular taxable year would be subject to Article 16 for that year even if it was paid after the close of the year. The determination as to whether the \$20,000 threshold has been exceeded is determined separately with respect to each year of payment. Accordingly, if an actor who is a resident of one Contracting State receives residual payments over time with respect to a movie that was filmed in the other Contracting State, the payments do not have to be aggregated from one year to another to determine whether the total payments have finally exceeded \$20,000. Otherwise, residual payments received many years later could retroactively subject all earlier payments to tax by the other Contracting State.

#### *Paragraph 2*

Paragraph 2 is intended to address the potential for circumvention of the rule in paragraph 1 when a performer's income does not accrue directly to the performer himself, but to another person. Foreign performers frequently perform in the United States as employees of, or under contract with, a company or other person.

The relationship may truly be one of employee and employer, with no circumvention of paragraph 1 either intended or realized. On the other hand, the “employer” may, for example, be a company established and owned by the performer, which is merely acting as the nominal income recipient in respect of the remuneration for the performance (a “star company”). The performer may act as an “employee,” receive a modest salary, and arrange to receive the remainder of the income from his performance from the company in another form or at a later time. In such case, absent the provisions of paragraph 2, the income arguably could escape host-country tax because the company earns business profits but has no permanent establishment in that country. The performer may largely or entirely escape host-country tax by receiving only a small salary, perhaps small enough to place him below the dollar threshold in paragraph 1. The performer might arrange to receive further payments in a later year, when he is not subject to host-country tax, perhaps as dividends or liquidating distributions.

Paragraph 2 seeks to prevent this type of abuse while at the same time protecting the taxpayers’ rights to the benefits of the Convention when there is a legitimate employee-employer relationship between the performer and the person providing his services. Under paragraph 2, when the income accrues to a person other than the performer, the income may be taxed in the Contracting State where the performer’s services are exercised, without regard to the provisions of the Convention concerning business profits (Article 7) or income from employment (Article 14), unless the contract pursuant to which the personal activities are performed allows the person other than the performer to designate the individual who is to perform the personal activities. This rule is based on the U.S. domestic law provision characterizing income from certain personal service contracts as foreign personal holding company income in the context of the foreign personal holding company provisions. See Code section 954(c)(1)(H). The premise of this rule is that, in a case where a performer is using another person in an attempt to circumvent the provisions of paragraph 1, the recipient of the services of the performer would contract with a person other than that performer (i.e., a company employing the performer) only if the recipient of the services were certain that the performer himself would perform the services. If instead the person is allowed to designate the individual who is to perform the services, then likely the person is a service company not formed to circumvent the provisions of paragraph 1. The following example illustrates the operation of this rule:

Example. Company M, a resident of Malta, is engaged in the business of operating an orchestra. Company M enters into a contract with Company A pursuant to which Company M agrees to carry out two performances in the United States in consideration of which Company A will pay Company M \$200,000. The contract designates two individuals, a conductor and a flautist, that must perform as part of the orchestra, and allows Company M to designate the other members of the orchestra. Because the contract does not give Company M any discretion to determine whether the conductor or the flautist perform personal services under the contract, the portion of the \$200,000 which is attributable to the per-



sonal services of the conductor and the flautist may be taxed by the United States pursuant to paragraph 2. The remaining portion of the \$200,000, which is attributable to the personal services of performers that Company M may designate, is not subject to tax by the United States pursuant to paragraph 2.

In cases where paragraph 2 is applicable, the income of the “employer” may be subject to tax in the host Contracting State even if it has no permanent establishment in the host country. Taxation under paragraph 2 is on the person providing the services of the performer. This paragraph does not affect the rules of paragraph 1, which apply to the performer himself. The income taxable by virtue of paragraph 2 is reduced to the extent of salary payments to the performer, which fall under paragraph 1.

For purposes of paragraph 2, income is deemed to accrue to another person (i.e., the person providing the services of the performer) if that other person has control over, or the right to receive, gross income in respect of the services of the performer.

Pursuant to Article 1 (General Scope) the Convention only applies to persons who are residents of one of the Contracting States. Thus, income of a star company that is not a resident of one of the Contracting States would not be eligible for benefits of the Convention.

#### *Relationship to Other Articles*

This Article is subject to the provisions of the saving clause of paragraph 4 of Article 1 (General Scope). Thus, if an entertainer or a sportsman who is resident in Malta is a citizen of the United States, the United States may tax all of his income from performances in the United States without regard to the provisions of this Article (subject to the special foreign tax credit provisions of paragraph 4 of Article 23 (Relief from Double Taxation)). In addition, benefits of this Article are subject to the provisions of Article 22 (Limitation on Benefits).

#### ARTICLE 17 (PENSIONS, SOCIAL SECURITY, ANNUITIES, ALIMONY, AND CHILD SUPPORT)

This Article deals with the taxation of private (i.e., non-government service) pensions and annuities, social security benefits, alimony and child support payments.

#### *Paragraph 1*

Paragraph 1 provides that distributions from pensions and other similar remuneration beneficially owned by a resident of a Contracting State in consideration of past employment are taxable only in the State of residence of the beneficiary. The term “pensions and other similar remuneration” includes both periodic and single sum payments.

The phrase “pensions and other similar remuneration” is intended to encompass payments made by qualified private retirement plans. In the United States, the plans encompassed by Paragraph 1 include: qualified plans under section 401(a), individual retirement plans (including individual retirement plans that are part of a simplified employee pension plan that satisfies section 408(k), individual retirement accounts and section 408(p) accounts), section

403(a) qualified annuity plans, and section 403(b) plans. Distributions from section 457 plans may also fall under Paragraph 1 if they are not paid with respect to government services covered by Article 19. The competent authorities may agree that distributions from other plans that generally meet similar criteria to those applicable to the listed plans also qualify for the benefits of Paragraph 1.

Pensions in respect of government services covered by Article 19 are not covered by this paragraph. They are covered either by paragraph 2 of this Article, if they are in the form of social security benefits, or by paragraph 2 of Article 19 (Government Service). Thus, Article 19 generally covers section 457(g), 401(a), 403(a), and 403(b) plans established for government employees, including the Thrift Savings Plan (section 7701(j)).

Subparagraph (b) contains an exception to the State of residence's right to tax pensions and other similar remuneration under subparagraph (a). Under subparagraph (b), the State of residence must exempt from tax any amount of such pensions or other similar remuneration that would be exempt from tax in the Contracting State in which the pension fund is established if the recipient were a resident of that State. Thus, for example, a distribution from a U.S. "Roth IRA" to a resident of Malta would be exempt from tax in Malta to the same extent the distribution would be exempt from tax in the United States if it were distributed to a U.S. resident. The same is true with respect to distributions from a traditional IRA to the extent that the distribution represents a return of non-deductible contributions. Similarly, if the distribution were not subject to tax when it was "rolled over" into another U.S. IRA (but not, for example, to a pension fund in the other Contracting State), then the distribution would be exempt from tax in Malta.

#### *Paragraph 2*

The treatment of social security benefits is dealt with in paragraph 2. This paragraph provides that, notwithstanding the provision of paragraph 1 under which private pensions are taxable exclusively in the State of residence of the beneficial owner, payments made by one of the Contracting States under the provisions of its social security or similar legislation to a resident of the other Contracting State or to a citizen of the United States will be taxable only in the Contracting State making the payment. The reference to U.S. citizens is necessary to ensure that a social security payment by Malta to a U.S. citizen who is not resident in the United States will not be taxable by the United States.

This paragraph applies to social security beneficiaries whether they have contributed to the system as private sector or Government employees. The phrase "similar legislation" is intended to refer to United States tier 1 Railroad Retirement benefits.

#### *Paragraph 3*

Under paragraph 3, annuities that are derived and beneficially owned by a resident of a Contracting State are taxable only in that State. An annuity, as the term is used in this paragraph, means a stated sum paid periodically at stated times during a specified number of years or for life, under an obligation to make the pay-

ment in return for adequate and full consideration (other than for services rendered). An annuity received in consideration for services rendered would be treated as either deferred compensation that is taxable in accordance with Article 14 (Income from Employment) or a pension that is subject to the rules of paragraph 1.

*Paragraphs 4 and 5*

Paragraphs 4 and 5 deal with alimony and child support payments. Both alimony, under paragraph 4, and child support payments, under paragraph 5, are defined as periodic payments made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support. Paragraph 4, however, deals only with payments of that type that are taxable to the payee. Under that paragraph, alimony paid by a resident of a Contracting State to a resident of the other Contracting State is taxable under the Convention only in the State of residence of the recipient. Paragraph 5 deals with those periodic payments that are for the support of a child and that are not covered by paragraph 4. These types of payments by a resident of a Contracting State to a resident of the other Contracting State are taxable in neither Contracting State.

*Relationship to Other Articles*

Paragraphs 1 (a), 3 and 4 of Article 17 are subject to the saving clause of paragraph 4 of Article 1 (General Scope). Thus, a U.S. citizen who is resident in Malta and receives either a pension, annuity or alimony payment from the United States, may be subject to U.S. tax on the payment, notwithstanding the rules in those three paragraphs that give the State of residence of the recipient the exclusive taxing right. Paragraphs 1(b), 2 and 5 are excepted from the saving clause by virtue of subparagraph 5(a) of Article 1. Thus, the United States will not tax U.S. citizens and residents on the income described in those paragraphs even if such amounts otherwise would be subject to tax under U.S. law.

ARTICLE 18 (PENSION FUNDS)

This Article provides that, if a resident of a Contracting State participates in a pension fund established in the other Contracting State, the State of residence will not tax the income of the pension fund with respect to that resident until a distribution is made from the pension fund. Thus, for example, if a U.S. citizen contributes to a U.S. qualified plan while working in the United States and then establishes residence in Malta, this Article prevents Malta from taxing currently the plan's earnings and accretions with respect to that individual. When the resident receives a distribution from the pension fund, that distribution may be subject to tax in Malta, subject to paragraph 1 of Article 17 (Pensions, Social Security, Annuities, Alimony, and Child Support).

*Relationship to other Articles*

Article 18 is excepted from the saving clause of paragraph 4 of Article 1 by virtue of paragraph 5(a) of Article 1. Thus, the United States will allow U.S. citizens and residents the benefits of Article 18.

## ARTICLE 19 (GOVERNMENT SERVICE)

*Paragraph 1*

Subparagraphs (a) and (b) of paragraph 1 deal with the taxation of government compensation (other than a pension addressed in paragraph 2). Subparagraph (a) provides that remuneration paid to any individual who is rendering services to a Contracting State, political subdivision or local authority is exempt from tax by the other State. Under subparagraph (b), such payments are, however, taxable exclusively in the other State (i.e., the host State) if the services are rendered in that other State and the individual is a resident of that State who is either a national of that State or a person who did not become resident of that State solely for purposes of rendering the services. The paragraph applies to anyone performing services for a government, whether as a government employee, an independent contractor, or an employee of an independent contractor.

*Paragraph 2*

Paragraph 2 deals with the taxation of pensions paid by, or out of funds created by, one of the States, or a political subdivision or a local authority thereof, to an individual in respect of services rendered to that State or subdivision or authority. Subparagraph (a) provides that such pensions are taxable only in that State. Subparagraph (b) provides an exception under which such pensions are taxable only in the other State if the individual is a resident of, and a national of, that other State.

Pensions paid to retired civilian and military employees of a Government of either State are intended to be covered under paragraph 2. When benefits paid by a State in respect of services rendered to that State or a subdivision or authority are in the form of social security benefits, however, those payments are covered by paragraph 2 of Article 17 (Pensions, Social Security, Annuities, Alimony, and Child Support). As a general matter, the result will be the same whether Article 17 or 19 applies, since social security benefits are taxable exclusively by the source country and so are government pensions. The result will differ only when the payment is made to a citizen and resident of the other Contracting State, who is not also a citizen of the paying State. In such a case, social security benefits continue to be taxable at source while government pensions become taxable only in the residence country.

*Paragraph 3*

Paragraph 3 provides that the remuneration described in paragraph 1 will be subject to the rules of Articles 14 (Income from Employment), 15 (Directors' Fees), 16 (Entertainers and Sportsmen) or 17 (Pensions, Social Security, Annuities, Alimony, and Child Support) if the recipient of the income is employed by a business conducted by a government.

*Relationship to Other Articles*

Under subparagraph 5(b) of Article 1 (General Scope), the saving clause of paragraph 4 of Article 1 does not apply to the benefits conferred by one of the States under Article 19 if the recipient of

the benefits is neither a citizen of that State, nor a person who has been admitted for permanent residence there (i.e., in the United States, a “green card” holder). Thus, a resident of the United States who in the course of performing functions of a governmental nature becomes a resident of Malta (but not a permanent resident), would be entitled to the benefits of this Article. Similarly, an individual who receives a pension paid by the Government of Malta in respect of services rendered to the Government of Malta shall be taxable on this pension only in Malta unless the individual is a U.S. citizen or acquires a U.S. green card.

#### ARTICLE 20 (STUDENTS AND TRAINEES)

This Article provides rules for host-country taxation of visiting students and business trainees. Persons who meet the tests of the Article will be exempt from tax in the State that they are visiting with respect to designated classes of income. Several conditions must be satisfied in order for an individual to be entitled to the benefits of this Article.

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

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

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

The Article also provides a limited exemption for remuneration from personal services rendered in the host State with a view to supplementing the resources available to him for such purposes to the extent of \$9,000 United States dollars (or its equivalent in Euros) per taxable year. The specified amount is intended to equalize the position of a U.S. resident who is entitled to the standard deduction and the personal exemption with that of a student who files as a nonresident alien and therefore is not. Accordingly, the competent authorities are instructed to adjust this amount every

five years, if necessary, to take into account changes in the amount of the U.S. standard deduction and personal exemption and in the Maltese personal tax rates.

In the case of a business trainee, the benefits of the Article will extend only for a period of one year from the time that the visitor first arrives in the host country. If, however, a trainee remains in the host country for a second year, thus losing the benefits of the Article, he would not retroactively lose the benefits of the Article for the first year. The term “business trainee” is defined as a person who is in the country temporarily for the purpose of securing training that is necessary to qualify to pursue a profession or professional specialty. Moreover, the person must be employed or under contract with a resident of the other Contracting State and must be receiving the training from someone who is not related to its employer. Thus, a business trainee might include a lawyer employed by a law firm in one Contracting State who works for one year as a stagiaire in an unrelated law firm in the other Contracting State. However, the term would not include a manager who normally is employed by a parent company in one Contracting State who is sent to the other Contracting State to run a factory owned by a subsidiary of the parent company.

#### *Relationship to Other Articles*

The saving clause of paragraph 4 of Article 1 (General Scope) does not apply to this Article with respect to an individual who is neither a citizen of the host State nor has been admitted for permanent residence there. The saving clause, however, does apply with respect to citizens and permanent residents of the host State. Thus, a U.S. citizen who is a resident of Malta and who visits the United States as a full-time student at an accredited university will not be exempt from U.S. tax on remittances from abroad that otherwise constitute U.S. taxable income. A person, however, who is not a U.S. citizen, and who visits the United States as a student and remains long enough to become a resident under U.S. law, but does not become a permanent resident (i.e., does not acquire a green card), will be entitled to the full benefits of the Article.

#### ARTICLE 21 (OTHER INCOME)

Article 21 assigns taxing jurisdiction over income not dealt with in the other articles (Articles 6 through 20) of the Convention. In order for an item of income to be “dealt with” in another article it must be the type of income described in the article and, in most cases, it must have its source in a Contracting State. For example, all royalty income that arises in a Contracting State and that is beneficially owned by a resident of the other Contracting State is “dealt with” in Article 12 (Royalties). However, profits derived in the conduct of a business are “dealt with” in Article 7 (Business Profits) whether or not they have their source in one of the Contracting States.

Examples of items of income covered by Article 21 include income from gambling, punitive (but not compensatory) damages and covenants not to compete. The article would also apply to income from a variety of financial transactions, where such income does not arise in the course of the conduct of a trade or business. For exam-

ple, income from notional principal contracts and other derivatives would fall within Article 21 if derived by persons not engaged in the trade or business of dealing in such instruments, unless such instruments were being used to hedge risks arising in a trade or business. It would also apply to securities lending fees derived by an institutional investor. Further, in most cases guarantee fees paid within an intercompany group would be covered by Article 21, unless the guarantor were engaged in the business of providing such guarantees to unrelated parties.

Article 21 also applies to items of income that are not dealt with in the other articles because of their source or some other characteristic. For example, Article 11 (Interest) addresses only the taxation of interest arising in a Contracting State. Interest arising in a third State that is not attributable to a permanent establishment, therefore, is subject to Article 21.

Distributions from partnerships are not generally dealt with under Article 21 because partnership distributions generally do not constitute income. Under the Code, partners include in income their distributive share of partnership income annually, and partnership distributions themselves generally do not give rise to income. This would also be the case under U.S. law with respect to distributions from trusts. Trust income and distributions that, under the Code, have the character of the associated distributable net income would generally be covered by another article of the Convention. See Code section 641 et seq.

#### *Paragraph 1*

The general rule of Article 21 is contained in paragraph 1. Items of income not dealt with in other articles and beneficially owned by a resident of a Contracting State will be taxable in the State of residence. This right of taxation applies whether or not the residence State exercises its right to tax the income covered by the Article. As discussed in greater detail below, however, where such income arises in the other Contracting State, paragraph 3 permits limited source-State taxation.

The reference in this paragraph to “items of income beneficially owned by a resident of a Contracting State” rather than simply “items of income of a resident of a Contracting State,” as in the OECD Model, is intended merely to make explicit the implicit understanding that the limits on source-State taxation provided by paragraphs 1 and 3 apply only when a resident of a Contracting State is the beneficial owner of the income. Thus, source taxation of income not dealt with in other articles of the Convention is not limited by paragraphs 1 and 3 if it is nominally paid to a resident of the other Contracting State, but is beneficially owned by a resident of a third State. However, income received by a nominee on behalf of a resident of that other State would be entitled to benefits.

The term “beneficially owned” is not defined in the Convention, and is, therefore, defined as under the internal law of the State granting treaty benefits (i.e., the source State). The person who beneficially owns the income for purposes of Article 21 is the person to which the income is attributable for tax purposes under the laws of the source State.

*Paragraph 2*

This paragraph provides an exception to the general rule of paragraph 1 for income that is attributable to a permanent establishment maintained in a Contracting State by a resident of the other Contracting State. The taxation of such income is governed by the provisions of Article 7 (Business Profits). Therefore, income arising outside the United States that is attributable to a permanent establishment maintained in the United States by a resident of Malta generally would be taxable by the United States under the provisions of Article 7. This would be true even if the income is sourced in a third State.

*Paragraph 3*

This paragraph provides for limited source-State taxation of income not dealt with in the foregoing Articles of the Convention. Such income of a resident of one of the Contracting States from sources in the other State may be taxed in the source State, but the rate may not exceed 10 percent of the amount of such items.

*Relationship to Other Articles*

This Article is subject to the saving clause of paragraph 4 of Article 1 (General Scope). Thus, the United States may tax the income of a resident of the other Contracting State that is not dealt with elsewhere in the Convention, if that resident is a citizen of the United States. The Article is also subject to the provisions of Article 22 (Limitation on Benefits). Thus, if a resident of the other Contracting State earns income that falls within the scope of paragraph 1 of Article 21, but that is taxable by the United States under U.S. law, the income would be exempt from U.S. tax under the provisions of Article 21 only if the resident satisfies one of the tests of Article 22 for entitlement to benefits.

## ARTICLE 22 (LIMITATION ON BENEFITS)

Article 22 contains anti-treaty-shopping provisions that are intended to prevent residents of third countries from benefiting from what is intended to be a reciprocal agreement between two countries. In general, the provision does not rely on a determination of purpose or intention but instead sets forth a series of objective tests. A resident of a Contracting State that satisfies one of the tests will receive benefits regardless of its motivations in choosing its particular business structure. However, the Exchange of Notes accompanying the Convention provides that a company resident in Malta that is an “international trading company,” as defined in article 2 of the Income Tax Act of Malta, shall be entitled to receive only the benefits of the Convention (subject to all applicable conditions or limitations) other than the benefits of Articles 10 (Dividends), 11 (Interest), 12 (Royalties), and 21 (Other Income) of the Convention.

The structure of the Article is as follows: Paragraph 1 states the general rule that residents are entitled to benefits otherwise accorded to residents only to the extent provided in the Article. Paragraph 2 lists a series of attributes of a resident of a Contracting State, the presence of any one of which will entitle that person to



all the benefits of the Convention. Paragraph 3 provides a so-called “derivative benefits” test under which certain categories of income may qualify for benefits. Paragraph 4 provides that, regardless of whether a person qualifies for benefits under paragraph 2, benefits may be granted to that person with regard to certain income earned in the conduct of an active trade or business. Paragraph 5 provides special rules for so-called “triangular cases,” notwithstanding the other provisions of the Article. Paragraph 6 provides that benefits also may be granted if the competent authority of the State from which benefits are claimed determines that it is appropriate to provide benefits in that case. Paragraph 7 addresses the application of the Convention where a remittance system of taxation is used. Paragraph 8 defines certain terms used in the Article.

#### *Paragraph 1*

Paragraph 1 provides that, except as otherwise provided, a resident of a Contracting State will be entitled to all the benefits otherwise accorded to residents of a Contracting State under the Convention only to the extent provided in the Article.

The benefits otherwise accorded to residents under the Convention include all limitations on source-based taxation under Articles 6 through 21, the treaty-based relief from double taxation provided by Article 23 (Relief from Double Taxation), and the protection afforded to residents of a Contracting State under Article 24 (Non-Discrimination). Some provisions do not require that a person be a resident in order to enjoy the benefits of those provisions. Article 25 (Mutual Agreement Procedure) is not limited to residents of the Contracting States, and Article 27 (Members of Diplomatic Missions and Consular Posts) applies to diplomatic agents or consular officials regardless of residence. Article 22 accordingly does not limit the availability of treaty benefits under these provisions.

Article 22 and the anti-abuse provisions of domestic law complement each other, as Article 22 effectively determines whether an entity has a sufficient nexus to the Contracting State to be treated as a resident for treaty purposes, while domestic anti-abuse provisions (e.g., business purpose, substance-over-form, step transaction or conduit principles) determine whether a particular transaction should be recast in accordance with its substance. Thus, internal law principles of the source Contracting State may be applied to identify the beneficial owner of an item of income, and Article 22 then will be applied to the beneficial owner to determine if that person is entitled to the benefits of the Convention with respect to such income.

#### *Paragraph 2*

Paragraph 2 has six subparagraphs, each of which describes a category of residents that are entitled to all benefits of the Convention.

It is intended that the provisions of paragraph 2 will be self-executing. Unlike the provisions of paragraph 6, discussed below, claiming benefits under paragraph 2 does not require advance competent authority ruling or approval. The tax authorities may, of

course, on review, determine that the taxpayer has improperly interpreted the paragraph and is not entitled to the benefits claimed.

*Individuals—Subparagraph 2(a)*

Subparagraph 2(a) provides that individual residents of a Contracting State will be entitled to all treaty benefits. If such an individual receives income as a nominee on behalf of a third country resident, benefits may be denied under the respective articles of the Convention by the requirement that the beneficial owner of the income be a resident of a Contracting State.

*Governments—Subparagraph 2(b)*

Subparagraph 2(b) provides that the Contracting States and any political subdivision or local authority thereof will be entitled to all benefits of the Convention.

*Publicly-Traded Corporations—Subparagraph 2(c)(i)*

Subparagraph 2(c) applies to two categories of companies: publicly traded companies and subsidiaries of publicly traded companies. A company resident in a Contracting State is entitled to all the benefits of the Convention under subparagraph 2(c)(i) if (a) the principal class of its shares, and any disproportionate class of shares, is listed on a recognized stock exchange located in the company's State of residence, (b) the principal class of its shares, and any disproportionate class of shares, regularly traded on one or more recognized stock exchanges in the company's State of residence, (c) the principal class of its shares is primarily traded on one or more recognized stock exchanges located in company's State of residence, and (d) and the company satisfies the base erosion test of subparagraph 2(f)(ii).

The term "recognized stock exchange" is defined in subparagraph (a) of paragraph 8. It includes (i) the NASDAQ System and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934, (ii) the Malta Stock Exchange, and (iii) any other stock exchange agreed upon by the competent authorities of the Contracting States.

If a company has only one class of shares, it is only necessary to consider whether the shares of that class meet the relevant trading requirements. If the company has more than one class of shares, it is necessary as an initial matter to determine which class or classes constitute the "principal class of shares." The term "principal class of shares" is defined in subparagraph 8(b) to mean the ordinary or common shares of the company representing the majority of the aggregate voting power and value of the company. If the company does not have a class of ordinary or common shares representing the majority of the aggregate voting power and value of the company, then the "principal class of shares" is that class or any combination of classes of shares that represents, in the aggregate, a majority of the voting power and value of the company. Although in a particular case involving a company with several classes of shares it is conceivable that more than one group of classes could be identified that account for more than 50% of the shares, it is only necessary for one such group to satisfy the requirements

of this subparagraph in order for the company to be entitled to benefits. Benefits would not be denied to the company even if a second, non-qualifying, group of shares with more than half of the company's voting power and value could be identified.

A company whose principal class of shares is regularly traded on a recognized stock exchange will nevertheless not qualify for benefits under subparagraph 2(c)(i) if it has a disproportionate class of shares that is not regularly traded on a recognized stock exchange. The term "disproportionate class of shares" is defined in subparagraph 8(c). A company has a disproportionate class of shares if it has outstanding a class of shares which is subject to terms or other arrangements that entitle the holder to a larger portion of the company's income, profit, or gain in the other Contracting State than that to which the holder would be entitled in the absence of such terms or arrangements. Thus, for example, a company resident in Malta meets the test of subparagraph 8(c) if it has outstanding a class of "tracking stock" that pays dividends based upon a formula that approximates the company's return on its assets employed in the United States.

The following example illustrates this result.

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

The term "regularly traded" is not defined in the Convention. In accordance with paragraph 2 of Article 3 (General Definitions), this term will be defined by reference to the domestic tax laws of the State from which treaty benefits are sought. In the case of the United States, this term is understood to have the meaning it has under Treas. Reg. section 1.884-5(d)(4)(i)(B), relating to the branch tax provisions of the Code. Under these regulations, a class of shares is considered to be "regularly traded" if two requirements are met: trades in the class of shares are made in more than de minimis quantities on at least 60 days during the taxable year, and the aggregate number of shares in the class traded during the year is at least 10 percent of the average number of shares outstanding during the year. Sections 1.884-5(d)(4)(i)(A), (ii) and (iii) will not be taken into account for purposes of defining the term "regularly traded" under the Convention.

The regular trading requirement can be met by trading on any recognized exchange or exchanges located in either State. Trading on one or more recognized stock exchanges may be aggregated for

purposes of this requirement. Thus, a U.S. company could satisfy the regularly traded requirement through trading, in whole or in part, on a recognized stock exchange located in Malta. Authorized but unissued shares are not considered for purposes of this test.

The term “primarily traded” is not defined in the Convention. In accordance with paragraph 2 of Article 3, this term will have the meaning it has under the laws of the State concerning the taxes to which the Convention applies, generally the source State. In the case of the United States, this term is understood to have the meaning it has under Treas. Reg. section 1.884–5(d)(3), relating to the branch tax provisions of the Code. Accordingly, stock of a corporation is “primarily traded” if the number of shares in the company’s principal class of shares that are traded during the taxable year on all recognized stock exchanges in the Contracting State of which the company is a resident exceeds the number of shares in the company’s principal class of shares that are traded during that year on established securities markets in any other single foreign country.

*Subsidiaries of Publicly-Traded Corporations—Subparagraph 2(c)(ii)*

A company resident in a Contracting State is entitled to all the benefits of the Convention under subparagraph 2(c)(ii) if five or fewer publicly traded companies described in subparagraph 2(c)(i) are the direct or indirect owners of at least 75 percent of each class of the company’s shares, and the company satisfies the base erosion test of subparagraph 2(f)(ii). If the publicly-traded companies are indirect owners, however, each of the intermediate companies must be a resident of the same Contracting State that is also entitled to benefits of the Convention under subparagraph 2(c)(ii).

Thus, for example, a company that is a resident of Malta, all the shares of which are owned by another company that is a resident of Malta, would qualify for benefits under subparagraph 2(c) if the principal class of shares (and any disproportionate classes of shares) of the parent company are regularly and primarily traded on the Malta Stock Exchange, and it satisfies the base erosion test of subparagraph 2(f)(ii). However, such a subsidiary would not qualify for benefits under clause (ii) if the publicly traded parent company were a resident of a third state. Furthermore, if a parent company in Malta indirectly owned the bottom-tier company through a chain of subsidiaries, each such subsidiary in the chain, as an intermediate owner, must be a resident of Malta entitled to the benefits of the convention under subparagraph 2(c)(ii) in order for the subsidiary to meet the test in clause (ii).

*Tax Exempt Organizations—Subparagraph 2(d)*

Subparagraph 2(d) provides rules by which the tax exempt organizations described in subparagraph 2(b) of Article 4 (Resident) will be entitled to all the benefits of the Convention. Entities qualifying under this rule generally are those that are exempt from tax in their State of residence and that are organized and operated exclusively to fulfill religious, charitable, scientific, artistic, cultural, or educational purposes.

*Pension Funds—Subparagraph 2(e)*

A pension fund will qualify for benefits under subparagraph 2(e) if more than 75 percent of the beneficiaries, members or participants of the pension fund are individuals resident in either Contracting State. For purposes of this provision, the term “beneficiaries” should be understood to refer to the persons receiving benefits from the organization.

*Ownership/Base Erosion—Subparagraph 2(f)*

Subparagraph 2(f) provides an additional method to qualify for treaty benefits that applies to any form of legal entity that is a resident of a Contracting State. The test provided in subparagraph (e), the so-called ownership and base erosion test, is a two-part test. Both prongs of the test must be satisfied for the resident to be entitled to treaty benefits under subparagraph 2(e).

The ownership prong of the test, under clause (i), requires that 75 percent or more of each class of shares or other beneficial interests in the person is owned, directly or indirectly, on at least half the days of the person’s taxable year by persons who are residents of the Contracting State of which that person is a resident and that are themselves entitled to treaty benefits under subparagraphs 2(a), 2(b), 2(c)(i), 2(d), or 2(e). In the case of indirect owners, however, each of the intermediate owners must be a qualified person that is also a resident of that Contracting State.

Trusts may be entitled to benefits under this provision if they are treated as residents under Article 4 (Residence) and they otherwise satisfy the requirements of this subparagraph. For purposes of this subparagraph, the beneficial interests in a trust will be considered to be owned by its beneficiaries in proportion to each beneficiary’s actuarial interest in the trust. The interest of a remainder beneficiary will be equal to 100 percent less the aggregate percentages held by income beneficiaries. A beneficiary’s interest in a trust will not be considered to be owned by a person entitled to benefits under subparagraphs 2(a), 2(b), 2(c)(i), 2(d), or 2(e) if it is not possible to determine the beneficiary’s actuarial interest. Consequently, if it is not possible to determine the actuarial interest of the beneficiaries in a trust, the ownership test under clause i) cannot be satisfied, unless all possible beneficiaries are persons entitled to benefits under subparagraphs 2(a), 2(b), 2(c)(i), 2(d), or 2(e).

The base erosion prong of clause (ii) of subparagraph (f) is satisfied with respect to a person if less than 25 percent of the person’s gross income for the taxable year, as determined under the tax law in the person’s State of residence, is paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State entitled to benefits under subparagraphs 2(a), 2(b), 2(c)(i), 2(d), or 2(e), other than in the form of arm’s-length payments in the ordinary course of business for services or tangible property.

*Paragraph 3*

Paragraph 3 sets forth a derivative benefits test that is potentially applicable to all treaty benefits, although the test is applied to individual items of income. In general, a derivative benefits test entitles a company that is a resident of a Contracting State to trea-

ty benefits if the owner of the company would have been entitled to the same benefit had the income in question flowed directly to that owner. To qualify under this paragraph, the company must meet an ownership test and a base erosion test.

Subparagraph (a) sets forth the ownership test. Under this test at least 95 percent of each class of shares of the company must be owned, directly or indirectly, by seven or fewer persons who are equivalent beneficiaries. The term “equivalent beneficiary” is defined in subparagraph 8(d). This definition may be met in two alternative ways, the first of which has two requirements.

Under the first alternative, a person may be an equivalent beneficiary because it is entitled to equivalent benefits under a treaty between the country of source and the country in which the person is a resident. This alternative has two requirements.

The first requirement is that the person must be a resident of a member state of the European Union, or of a European Economic Area state, or of Australia, or of a party to the North American Free Trade Agreement (collectively, “qualifying States”).

The second requirement of the definition of “equivalent beneficiary” is that the person must be entitled to equivalent benefits under an applicable treaty. To satisfy the second requirement, the person must be entitled to all the benefits of a comprehensive treaty between the Contracting State from which benefits of the Convention are claimed and a qualifying State under provisions that are analogous to the rules in subparagraphs 2(a), 2(b), 2(c)(i), 2(d), or 2(e) of this Article. If the treaty in question does not have a comprehensive limitation on benefits article, this requirement is met only if the person would be entitled to treaty benefits under the tests in subparagraphs 2(a), 2(b), 2(c)(i), 2(d), or 2(e) of this Article if the person were a resident of one of the Contracting States.

In order to satisfy the second requirement necessary to qualify as an “equivalent beneficiary” under subparagraph 8(d)(i)(B) with respect to dividends, interest, royalties or branch tax, the person must be entitled to a rate of tax that is at least as low as the tax rate that would apply under the Convention to such income. Thus, the rates to be compared are: (1) the rate of tax that the source State would have imposed if a qualified resident of the other Contracting State was the beneficial owner of the income; and (2) the rate of tax that the source State would have imposed if the third State resident received the income directly from the source State. For example, USCo is a wholly owned subsidiary of MCo, a company resident in Malta. MCo is wholly owned by ICo, a corporation resident in Italy. Assuming MCo satisfied the requirements of paragraph 2 of Article 10 (Dividends), MCo would be eligible for a dividend withholding tax rate of 5 percent. The dividend withholding tax rate in the treaty between the United States and Italy is 5 percent. Thus, if ICo received the dividend directly from USCo, ICo would be subject to a 5 percent rate of withholding tax on the dividend. Because ICo would be entitled to a rate of withholding tax that is at least as low as the rate that would apply under the Convention to such income, ICo is treated as a resident of a member state of the European Union or a party to the North American Free Trade Agreement with respect to the withholding tax on dividends.

Subparagraph 8(e) provides a special rule to take account of the fact that withholding taxes on many inter-company dividends, interest and royalties are exempt within the European Union by reason of various EU directives, rather than by tax treaty. If a U.S. company receives such payments from a Maltese company, and that U.S. company is owned by a company resident in a member state of the European Union that would have qualified for an exemption from withholding tax if it had received the income directly, the parent company will be treated as an equivalent beneficiary. This rule is necessary because many European Union member countries have not re-negotiated their tax treaties to reflect the exemptions available under the directives.

The requirement that a person be entitled to “all the benefits” of a comprehensive tax treaty eliminates those persons that qualify for benefits with respect to only certain types of income. Accordingly, the fact that a French parent of a Maltese company is engaged in the active conduct of a trade or business in France and therefore would be entitled to the benefits of the U.S.-France treaty if it received dividends directly from a U.S. subsidiary of the Maltese company is not sufficient for purposes of this paragraph. Further, the French company cannot be an equivalent beneficiary if it itself qualifies for benefits only with respect to certain income as a result of a “derivative benefits” provision in the U.S.-France treaty. However, it would be possible to look through the French company to its parent company to determine whether the parent company is an equivalent beneficiary.

The second alternative for satisfying the “equivalent beneficiary” test is available only to residents of one of the two Contracting States. U.S. or Maltese residents who are eligible for treaty benefits by reason of subparagraphs 2(a), 2(b), 2(c)(i), 2(d), or 2(e) are equivalent beneficiaries for purposes of the relevant tests in this Article. Thus, a Maltese individual will be an equivalent beneficiary without regard to whether the individual would have been entitled to receive the same benefits if it received the income directly. A resident of a third country cannot qualify for treaty benefits under these provisions by reason of those paragraphs or any other rule of the treaty, and therefore does not qualify as an equivalent beneficiary under this alternative. Thus, a resident of a third country can be an equivalent beneficiary only if it would have been entitled to equivalent benefits had it received the income directly.

The second alternative was included in order to clarify that ownership by certain residents of a Contracting State would not disqualify a U.S. or Maltese company under this paragraph. Thus, for example, if 90 percent of a Maltese company is owned by five companies that are resident in member states of the European Union who satisfy the requirements of subparagraph 8(d)(i), and 10 percent of the Maltese company is owned by a U.S. or Maltese individual, then the Maltese company still can satisfy the requirements of subparagraph 3(a).

Subparagraph 3(b) sets forth the base erosion test. A company meets this base erosion test if less than 25 percent of its gross income (as determined in the company’s State of residence) for the taxable period is paid or accrued, directly or indirectly, to a person or persons who are not equivalent beneficiaries. These amounts do

not include arm's-length payments in the ordinary course of business for services or tangible property. This test is the same as the base erosion test in subparagraph 2(f)(ii), except that the test in paragraph 3(b) focuses on base-eroding payments to persons who are not equivalent beneficiaries.

*Paragraph 4*

Paragraph 4 sets forth an alternative test under which a resident of a Contracting State may receive treaty benefits with respect to certain items of income that are connected to an active trade or business conducted in its State of residence. A resident of a Contracting State may qualify for benefits under paragraph 4 whether or not it also qualifies under paragraph 2 or 3.

Subparagraph 4(a) sets forth the general rule that a resident of a Contracting State engaged in the active conduct of a trade or business in that State may obtain the benefits of the Convention with respect to an item of income derived in the other Contracting State. The item of income, however, must be derived in connection with or incidental to that trade or business. In addition, the resident must satisfy the base erosion test of clause (ii) of subparagraph 2(f).

The term "trade or business" is not defined in the Convention. Pursuant to paragraph 2 of Article 3 (General Definitions), when determining whether a resident of Malta is entitled to the benefits of the Convention under paragraph 4 of this Article with respect to an item of income derived from sources within the United States, the United States will ascribe to this term the meaning that it has under the law of the United States. Accordingly, the U.S. competent authority will refer to the regulations issued under section 367(a) for the definition of the term "trade or business." In general, therefore, a trade or business will be considered to be a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit. Furthermore, a corporation generally will be considered to carry on a trade or business only if the officers and employees of the corporation conduct substantial managerial and operational activities.

The business of making or managing investments for the resident's own account will be considered to be a trade or business only when part of banking or insurance activities conducted by a bank or an insurance company. Such activities conducted by a person other than a bank or insurance company will not be considered to be the conduct of an active trade or business, nor would they be considered to be the conduct of an active trade or business if conducted by a bank or insurance company but not as part of the company's banking or insurance business. Because a headquarters operation is in the business of managing investments, a company that functions solely as a headquarters company will not be considered to be engaged in an active trade or business for purposes of paragraph 4.

An item of income is derived in connection with a trade or business if the income-producing activity in the State of source is a line of business that "forms a part of or is "complementary" to the trade or business conducted in the State of residence by the income recipient.



A business activity generally will be considered to form part of a business activity conducted in the State of source if the two activities involve the design, manufacture or sale of the same products or type of products, or the provision of similar services. The line of business in the State of residence may be upstream, downstream, or parallel to the activity conducted in the State of source. Thus, the line of business may provide inputs for a manufacturing process that occurs in the State of source, may sell the output of that manufacturing process, or simply may sell the same sorts of products that are being sold by the trade or business carried on in the State of source.

*Example 1.* USCo is a corporation resident in the United States. USCo is engaged in an active manufacturing business in the United States. USCo owns 100 percent of the shares of MCo, a corporation resident in Malta. MCo distributes USCo products in Malta. Since the business activities conducted by the two corporations involve the same products, MCo's distribution business is considered to form a part of USCo's manufacturing business.

*Example 2.* The facts are the same as in Example 1, except that USCo does not manufacture. Rather, USCo operates a large research and development facility in the United States that licenses intellectual property to affiliates worldwide, including MCo. MCo and other USCo affiliates then manufacture and market the USCo-designed products in their respective markets. Since the activities conducted by MCo and USCo involve the same product lines, these activities are considered to form a part of the same trade or business.

For two activities to be considered to be "complementary," the activities need not relate to the same types of products or services, but they should be part of the same overall industry and be related in the sense that the success or failure of one activity will tend to result in success or failure for the other. Where more than one trade or business is conducted in the State of source and only one of the trades or businesses forms a part of or is complementary to a trade or business conducted in the State of residence, it is necessary to identify the trade or business to which an item of income is attributable. Royalties generally will be considered to be derived in connection with the trade or business to which the underlying intangible property is attributable. Dividends will be deemed to be derived first out of earnings and profits of the treaty-benefited trade or business, and then out of other earnings and profits. Interest income may be allocated under any reasonable method consistently applied. A method that conforms to U.S. principles for expense allocation will be considered a reasonable method.

*Example 3.* Americair is a corporation resident in the United States that operates an international airline. MSub is a wholly-owned subsidiary of Americair resident in Malta. MSub operates a chain of hotels in Malta that are located near airports served by Americair flights. Americair frequently sells tour packages that include air travel to Malta and lodging at MSub hotels. Although both companies are engaged in the active conduct of a trade or business, the businesses of operating a chain of hotels and operating an airline are distinct trades or businesses. Therefore MSub's business does not form a part of Americair's business. However,

MSub's business is considered to be complementary to Americair's business because they are part of the same overall industry (travel) and the links between their operations tend to make them interdependent.

*Example 4.* The facts are the same as in Example 3, except that MSub owns an office building in Malta instead of a hotel chain. No part of Americair's business is conducted through the office building. MSub's business is not considered to form a part of or to be complementary to Americair's business. They are engaged in distinct trades or businesses in separate industries, and there is no economic dependence between the two operations.

*Example 5.* USFlower is a corporation resident in the United States. USFlower produces and sells flowers in the United States and other countries. USFlower owns all the shares of M Holding, a corporation resident in Malta. M Holding is a holding company that is not engaged in a trade or business. M Holding owns all the shares of three corporations that are resident in Malta: MFlower, MLawn, and MFish. MFlower distributes USFlower flowers under the USFlower trademark in Malta. MLawn markets a line of lawn care products in Malta under the USFlower trademark. In addition to being sold under the same trademark, MLawn and MFlower products are sold in the same stores and sales of each company's products tend to generate increased sales of the other's products. MFish imports fish from the United States and distributes it to fish wholesalers in Malta. For purposes of paragraph 4, the business of MFlower forms a part of the business of USFlower, the business of MLawn is complementary to the business of USFlower, and the business of MFish is neither part of nor complementary to that of USFlower.

An item of income derived from the State of source is "incidental to" the trade or business carried on in the State of residence if production of the item facilitates the conduct of the trade or business in the State of residence. An example of incidental income is the temporary investment of working capital of a person in the State of residence in securities issued by persons in the State of source.

Subparagraph 4(b) states a further condition to the general rule in clause (i) of subparagraph (a) in cases where the trade or business generating the item of income in question is carried on either by the person deriving the income or by any associated enterprises. Subparagraph 4(b) states that the trade or business carried on in the State of residence, under these circumstances, must be substantial in relation to the activity in the State of source. The substantiality requirement is intended to prevent a narrow case of treaty-shopping abuses in which a company attempts to qualify for benefits by engaging in de minimis connected business activities in the treaty country in which it is resident (i.e., activities that have little economic cost or effect with respect to the company business as a whole).

A trade or business will be deemed substantial if, for each of the three preceding taxable years, the asset value, the gross income, and the payroll expense that are related to the trade or business in the first-mentioned Contracting State each equals at least 10 percent of the resident's (and any related parties') proportionate share of the asset value, gross income, and payroll expense, respec-

tively, related to the activity that generated the income in the other Contracting State, and the average of the three ratios in each such year exceeds 15 percent.

The determination in subparagraph 4(b) is made separately for each item of income derived from the State of source. It therefore is possible that a person would be entitled to the benefits of the Convention with respect to one item of income but not with respect to another. If a resident of a Contracting State is entitled to treaty benefits with respect to a particular item of income under paragraph 4, the resident is entitled to all benefits of the Convention insofar as they affect the taxation of that item of income in the State of source.

The application of the substantiality requirement only to income from related parties focuses only on potential abuse cases, and does not hamper certain other kinds of non-abusive activities, even though the income recipient resident in a Contracting State may be very small in relation to the entity generating income in the other Contracting State. For example, if a small U.S. research firm develops a process that it licenses to a very large, unrelated, pharmaceutical manufacturer in Malta, the size of the U.S. research firm would not have to be tested against the size of the manufacturer. Similarly, a small U.S. bank that makes a loan to a very large unrelated company operating a business in Malta would not have to pass a substantiality test to receive treaty benefits under Paragraph 4.

Subparagraph 4(c) provides special attribution rules for purposes of applying the substantive rules of subparagraphs 4(a) and 4(b). Thus, these rules apply for purposes of determining whether a person meets the requirement in subparagraph 4(a)(i) that it be engaged in the active conduct of a trade or business and that the item of income is derived in connection with that active trade or business, and for making the comparison required by the “substantiality” requirement in subparagraph 4(b). Subparagraph 4(c) attributes to a person activities conducted by persons “connected” to such person. A person (“X”) is connected to another person (“Y”) if X possesses 50 percent or more of the beneficial interest in Y (or if Y possesses 50 percent or more of the beneficial interest in X). For this purpose, X is connected to a company if X owns shares representing fifty percent or more of the aggregate voting power and value of the company or fifty percent or more of the beneficial equity interest in the company. X also is connected to Y if a third person possesses fifty percent or more of the beneficial interest in both X and Y. For this purpose, if X or Y is a company, the threshold relationship with respect to such company or companies is fifty percent or more of the aggregate voting power and value or fifty percent or more of the beneficial equity interest. Finally, X is connected to Y if, based upon all the facts and circumstances, X controls Y, Y controls X, or X and Y are controlled by the same person or persons.

#### *Paragraph 5*

Paragraph 5 deals with the treatment of income in the context of a so-called “triangular case.”

An example of a triangular case would be a structure under which a resident of Malta earns interest income from the United States. The resident of Malta, who is assumed to qualify for benefits under one or more of the provisions of this Article, sets up a permanent establishment in a third jurisdiction that imposes only a low rate of tax on the income of the permanent establishment. The Maltese resident lends funds into the United States through the permanent establishment. The permanent establishment, despite its third-jurisdiction location, is an integral part of a Maltese resident. Therefore the income that it earns on those loans, absent the provisions of paragraph 5, is entitled to a reduced rate of withholding tax under the Convention. Under a current Maltese income tax treaty with the host jurisdiction of the permanent establishment, the income of the permanent establishment is exempt from Maltese tax (alternatively, Malta may choose to exempt the income of the permanent establishment from Maltese income tax by statute). Thus, the interest income is exempt from U.S. tax, is subject to little tax in the host jurisdiction of the permanent establishment, and is exempt from Maltese tax.

Paragraph 5 applies reciprocally. However, the United States does not exempt the profits of a third-jurisdiction permanent establishment of a U.S. resident from U.S. tax, either by statute or by treaty.

Paragraph 5 provides that the tax benefits that would otherwise apply under the Convention will not apply to any item of income if the combined tax actually paid in the residence State and the third state is less than 60 percent of the tax that would have been payable in the residence State if the income were earned in that State by the enterprise and were not attributable to the permanent establishment in the third state. In the case of dividends, interest and royalties to which this paragraph applies, the withholding tax rates under the Convention are replaced with a 15 percent withholding tax. Any other income to which the provisions of paragraph 5 apply is subject to tax under the domestic law of the source State, notwithstanding any other provisions of the Convention.

In general, the principles employed under Code section 954(b)(4) will be employed to determine whether the profits are subject to an effective rate of taxation that is above the specified threshold.

#### *Paragraph 6*

Paragraph 6 provides that a resident of one of the States that is not entitled to the benefits of the Convention as a result of paragraphs 1 through 5 still may be granted benefits under the Convention at the discretion of the competent authority of the State from which benefits are claimed.

The competent authority's discretion is quite broad. It may grant all of the benefits of the Convention to the taxpayer making the request, or it may grant only certain benefits. For instance, it may grant benefits only with respect to a particular item of income in a manner similar to paragraph 4. Further, the competent authority may establish conditions, such as setting time limits on the duration of any relief granted.

For purposes of implementing paragraph 6, a taxpayer will be permitted to present his case to the relevant competent authority

for an advance determination based on the facts. In these circumstances, it is also expected that, if the competent authority determines that benefits are to be allowed, they will be allowed retroactively to the time of entry into force of the relevant treaty provision or the establishment of the structure in question, whichever is later.

Finally, there may be cases in which a resident of a Contracting State may apply for discretionary relief to the competent authority of his State of residence. This would arise, for example, if the benefit it is claiming is provided by the residence country, and not by the source country. So, for example, if a company that is a resident of the United States would like to claim the benefit of the resourcing rule of paragraph 3 of Article 23, but it does not meet any of the objective tests of paragraphs 2 through 4, it may apply to the U.S. competent authority for discretionary relief.

#### *Paragraph 7*

Paragraph 7 is included in this Article because Malta continues to maintain a remittance system of taxation for individuals who are resident but not domiciled in Malta. Such persons are subject to tax in Malta on non-Maltese source income only to the extent that the income or gains are remitted to Malta. Under paragraph 7, such persons are entitled to the benefits of the Convention in order to reduce or eliminate tax only to the extent that the relevant income is remitted to or received in Malta. For example, if a Maltese resident who is not domiciled in Malta maintains a brokerage account in a third country into which is paid \$100 in U.S.-source dividend income, the U.S. may impose withholding tax at the statutory rate of 30 percent because the dividend income will not be taxed in Malta as it has not been remitted to Malta. If the dividend income instead is paid into a brokerage account in Malta, the Maltese resident will be subject to tax in Malta and the United States will reduce the rate of withholding tax to 15 percent.

#### *Paragraph 8*

Paragraph 5 defines several key terms for purposes of Article 22. Each of the defined terms is discussed above in the context in which it is used.

### ARTICLE 23 (RELIEF FROM DOUBLE TAXATION)

This Article describes the manner in which each Contracting State undertakes to relieve double taxation. The United States uses the foreign tax credit method under its internal law, and by treaty.

#### *Paragraph 1*

The United States agrees, in paragraph 1, to allow to its citizens and residents a credit against U.S. tax for income taxes paid or accrued to Malta. Paragraph 1 also provides that Malta's covered taxes are income taxes for U.S. purposes. This provision is based on the Treasury Department's review of Malta's laws.

Subparagraph 1(b) provides for a deemed-paid credit, consistent with section 902 of the Code, to a U.S. corporation in respect of dividends received from a corporation resident in Malta of which

the U.S. corporation owns at least 10 percent of the voting stock. This credit is for the tax paid by the corporation to Malta on the profits out of which the dividends are considered paid.

The credits allowed under paragraph 1 are allowed in accordance with the provisions and subject to the limitations of U.S. law, as that law may be amended over time, so long as the general principle of the Article, that is, the allowance of a credit, is retained. Thus, although the Convention provides for a foreign tax credit, the terms of the credit are determined by the provisions, at the time a credit is given, of the U.S. statutory credit.

Therefore, the U.S. credit under the Convention is subject to the various limitations of U.S. law (see, e.g., Code sections 901-908). For example, the credit against U.S. tax generally is limited to the amount of U.S. tax due with respect to net foreign source income within the relevant foreign tax credit limitation category (see Code section 904(a) and (d)), and the dollar amount of the credit is determined in accordance with U.S. currency translation rules (see, e.g., Code section 986). Similarly, U.S. law applies to determine carry-over periods for excess credits and other inter-year adjustments.

There is a typographical error in the flush language following paragraph subparagraph 1(b), which describes the taxes that will be considered income taxes for purposes of paragraph 1.

The provision as drafted refers to subparagraph 3(a) of Article 2 (Taxes Covered), which describes the U.S. taxes covered by the Convention. It should refer instead to subparagraph 3(b).

#### *Paragraph 2*

Paragraph 2 provides that Malta will provide relief from double taxation through the credit method. Malta agrees in subparagraph 2(a), in accordance with and subject to the provisions of the law of Malta, to allow a credit against Maltese tax for income taxes payable on U.S.-source income.

Subparagraph 2(b) applies where a Maltese company owns at least 10 percent of the voting stock of a U.S. company from which the Maltese company receives dividends that are included in a Malta assessment in accordance with the Convention. In such a case, the income tax paid or accrued to the United States by or on behalf of the payer with respect to the profits out of which the dividends are paid shall, if those profits are included in a Malta assessment, be allowed as a credit against the relative Malta tax payable thereon.

#### *Paragraph 3*

Paragraph 3 provides a re-sourcing rule for gross income covered by paragraph 1. Paragraph 3 is intended to ensure that a U.S. resident can obtain an appropriate amount of U.S. foreign tax credit for income taxes paid to Malta when the Convention assigns to Malta primary taxing rights over an item of gross income.

Accordingly, if the Convention allows Malta to tax an item of gross income (as defined under U.S. law) derived by a resident of the United States, the United States will treat that item of gross income as gross income from sources within Malta for U.S. foreign tax credit purposes. In the case of a U.S.-owned foreign corporation, however, section 904(g)(10) may apply for purposes of deter-

mining the U.S. foreign tax credit with respect to income subject to this re-sourcing rule. Section 904(g)(10) generally applies the foreign tax credit limitation separately to re-sourced income. Furthermore, the paragraph 3 re-sourcing rule applies to gross income, not net income. Accordingly, U.S. expense allocation and apportionment rules, see, e.g., Treas. Reg. section 1.861-9, continue to apply to income resourced under paragraph 3.

#### *Paragraph 4*

Paragraph 4 provides special rules for the tax treatment in both States of certain types of income derived from U.S. sources by U.S. citizens who are residents of Malta. Since U.S. citizens, regardless of residence, are subject to United States tax at ordinary progressive rates on their worldwide income, the U.S. tax on the U.S. source income of a U.S. citizen resident in Malta may exceed the U.S. tax that may be imposed under the Convention on an item of U.S. source income derived by a resident of Malta who is not a U.S. citizen. The provisions of paragraph 4 ensure that Malta does not bear the cost of U.S. taxation of its citizens who are residents of Malta.

Subparagraph 4(a) provides, with respect to items of income from sources within the United States, special credit rules for Malta. These rules apply to items of U.S.-source income that would be either exempt from U.S. tax or subject to reduced rates of U.S. tax under the provisions of the Convention if they had been received by a resident of Malta who is not a U.S. citizen. The tax credit allowed under paragraph 4 with respect to such items need not exceed the U.S. tax that may be imposed under the Convention, other than tax imposed solely by reason of the U.S. citizenship of the taxpayer under the provisions of the saving clause of paragraph 4 of Article 1 (General Scope).

For example, if a U.S. citizen resident in Malta receives a payment of royalties from sources within the United States, the foreign tax credit granted by Malta would be limited to 10 percent of the gross amount of the royalties—the U.S. tax that may be imposed under paragraph 2 of Article 12 (Royalties)—even if the shareholder is subject to U.S. net income tax because of his U.S. citizenship.

Subparagraph 4(b) eliminates the potential for double taxation that can arise because subparagraph 4(a) provides that Malta need not provide full relief for the U.S. tax imposed on its citizens resident in Malta. Subparagraph 4(b) provides that the United States will credit the income tax paid or accrued to Malta, after the application of subparagraph 4(a). It further provides that in allowing the credit, the United States will not reduce its tax below the amount that is taken into account in Malta in applying subparagraph 4(a).

Since the income described in subparagraph 4(a) generally will be U.S. source income, special rules are required to re-source some of the income to Malta in order for the United States to be able to credit the tax paid to Malta. This re-sourcing is provided for in subparagraph 4(c), which deems the items of income referred to in subparagraph 4(a) to be from foreign sources to the extent necessary to avoid double taxation under paragraph 4(b). Clause (iii)

of subparagraph 3(c) of Article 25 (Mutual Agreement Procedure) provides a mechanism by which the competent authorities can resolve any disputes regarding whether income is from sources within the United States.

The following two examples illustrate the application of paragraph 4 in the case of U.S. source royalties received by a U.S. citizen resident in Malta. In both examples, the U.S. rate of tax on residents of Malta, under paragraph 2 of Article 12 (Royalties) of the Convention, is 10 percent. In both examples, the U.S. income tax rate on the U.S. citizen is 35 percent. In example 1, the rate of income tax imposed in Malta on its resident (the U.S. citizen) is 25 percent (below the U.S. rate), and in example 2, the rate imposed on its resident is 40 percent (above the U.S. rate).

	Example 1	Example 2
Subparagraph (a):		
U.S.-source royalty payment .....	\$100.00	\$100.00
Notional U.S. withholding tax (Article 10(2)(a)) .....	10.00	10.00
Taxable income in Malta .....	100.00	100.00
Maltese tax before credit .....	25.00	40.00
Less: tax credit for notional U.S. withholding tax .....	10.00	10.00
Net post-credit tax paid to Malta .....	15.00	30.00
Subparagraphs (b) and (c):		
U.S. pre-tax income .....	\$100.00	\$100.00
U.S. pre-credit citizenship tax .....	35.00	35.00
Notional U.S. withholding tax .....	10.00	10.00
U.S. tax eligible to be offset by credit .....	25.00	25.00
Tax paid to Malta .....	15.00	30.00
Income re-sourced from U.S. to foreign source (see below) .....	42.86	71.43
U.S. pre-credit tax on re-sourced income .....	15.00	25.00
U.S. credit for tax paid to Malta .....	15.00	25.00
Net post-credit U.S. tax .....	10.00	0.00
Total U.S. tax .....	20.00	10.00

In both examples, in the application of subparagraph (a), Malta credits a 10 percent U.S. tax against its residence tax on the U.S. citizen. In the first example, the net tax paid to Malta after the foreign tax credit is \$15.00; in the second example, it is \$30.00. In the application of subparagraphs (b) and (c), from the U.S. tax due before credit of \$35.00, the United States subtracts the amount of the U.S. source tax of \$10.00, against which no U.S. foreign tax credit is allowed. This subtraction ensures that the United States collects the tax that it is due under the Convention as the State of source.

In both examples, given the 35 percent U.S. tax rate, the maximum amount of U.S. tax against which credit for the tax paid to Malta may be claimed is \$25 (\$35 U.S. tax minus \$10 U.S. withholding tax). Initially, all of the income in both examples was from sources within the United States. For a U.S. foreign tax credit to be allowed for the full amount of the tax paid to Malta, an appropriate amount of the income must be treated as foreign-source income under subparagraph (c).

The amount that must be re-sourced depends on the amount of tax for which the U.S. citizen is claiming a U.S. foreign tax credit. In example 1, the tax paid to Malta was \$15. For this amount to be creditable against U.S. tax, \$42.86 (\$15 tax divided by 35 percent U.S. tax rate) must be resourced as foreign-source income. When the tax is credited against the \$15 of U.S. tax on this



resourced income, there is a net U.S. tax of \$10 due after credit (\$25 U.S. tax eligible to be offset by credit, minus \$15 tax paid to Malta). Thus, in example 1, there is a total of \$20 in U.S. tax (\$10 U.S. withholding tax plus \$10 residual U.S. tax).

In example 2, the tax paid to Malta was \$30, but, because the United States subtracts the U.S. withholding tax of \$10 from the total U.S. tax of \$35, only \$25 of U.S. taxes may be offset by taxes paid to Malta. Accordingly, the amount that must be resourced to Malta is limited to the amount necessary to ensure a U.S. foreign tax credit for \$25 of tax paid to Malta, or \$71.43 (\$25 tax paid to the other Contracting State divided by 35 percent U.S. tax rate). When the tax paid to Malta is credited against the U.S. tax on this re-sourced income, there is no residual U.S. tax (\$25 U.S. tax minus \$30 tax paid to Malta, subject to the U.S. limit of \$25). Thus, in example 2, there is a total of \$10 in U.S. tax (\$10 U.S. withholding tax plus \$0 residual U.S. tax). Because the tax paid to Malta was \$30 and the U.S. tax eligible to be offset by credit was \$25, there is \$5 of excess foreign tax credit available for carryover.

#### *Relationship to Other Articles*

By virtue of subparagraph (a) of paragraph 5 of Article 1 (General Scope), Article 23 is not subject to the saving clause of paragraph 4 of Article 1. Thus, the United States will allow a credit to its citizens and residents in accordance with the Article, even if such credit were to provide a benefit not available under the Code (such as the re-sourcing provided by paragraph 3 and subparagraph 4(c)).

#### ARTICLE 24 (NON-DISCRIMINATION)

This Article ensures that nationals of a Contracting State, in the case of paragraph 1, and residents of a Contracting State, in the case of paragraphs 2 through 5, will not be subject, directly or indirectly, to discriminatory taxation in the other Contracting State. Not all differences in tax treatment, either as between nationals of the two States, or between residents of the two States, are violations of the prohibition against discrimination. Rather, the non-discrimination obligations of this Article apply only if the nationals or residents of the two States are comparably situated.

Each of the relevant paragraphs of the Article provides that two persons that are comparably situated must be treated similarly. Although the actual words differ from paragraph to paragraph (e.g., paragraph 1 refers to two nationals “in the same circumstances,” paragraph 2 refers to two enterprises “carrying on the same activities” and paragraph 4 refers to two enterprises that are “similar”), the common underlying premise is that if the difference in treatment is directly related to a tax-relevant difference in the situations of the domestic and foreign persons being compared, that difference is not to be treated as discriminatory (i.e., if one person is taxable in a Contracting State on worldwide income and the other is not, or tax may be collectible from one person at a later stage, but not from the other, distinctions in treatment would be justified under paragraph 1). Other examples of such factors that can lead to nondiscriminatory differences in treatment are noted in the discussions of each paragraph.

The operative paragraphs of the Article also use different language to identify the kinds of differences in taxation treatment that will be considered discriminatory. For example, paragraphs 1 and 4 speak of “any taxation or any requirement connected therewith that is more burdensome,” while paragraph 2 specifies that a tax “shall not be less favorably levied.” Regardless of these differences in language, only differences in tax treatment that materially disadvantage the foreign person relative to the domestic person are properly the subject of the Article.

*Paragraph 1*

Paragraph 1 provides that a national of one Contracting State may not be subject to taxation or connected requirements in the other Contracting State that are more burdensome than the taxes and connected requirements imposed upon a national of that other State in the same circumstances. The OECD Model prohibits taxation that is “other than or more burdensome” than that imposed on U.S. persons. This Convention omits the reference to taxation that is “other than” that imposed on U.S. persons because the only relevant question under this provision should be whether the requirement imposed on a national of the other Contracting State is more burdensome. A requirement may be different from the requirements imposed on U.S. nationals without being more burdensome.

The term “national” in relation to a Contracting State is defined in subparagraph 1(j) of Article 3 (General Definitions). The term includes both individuals and juridical persons. A national of a Contracting State is afforded protection under this paragraph even if the national is not a resident of either Contracting State. Thus, a U.S. citizen who is resident in a third country is entitled, under this paragraph, to the same treatment in Malta as a national of Malta who is in similar circumstances (i.e., presumably one who is resident in a third State).

As noted above, whether or not the two persons are both taxable on worldwide income is a significant circumstance for this purpose. For this reason, paragraph 1 specifically states that the United States is not obligated to apply the same taxing regime to a national of Malta who is not resident in the United States as it applies to a U.S. national who is not resident in the United States. United States citizens who are not residents of the United States but who are, nevertheless, subject to United States tax on their worldwide income are not in the same circumstances with respect to United States taxation as citizens of Malta who are not United States residents. Thus, for example, Article 24 would not entitle a national of Malta resident in a third country to taxation at graduated rates on U.S. source dividends or other investment income that applies to a U.S. citizen resident in the same third country.

*Paragraph 2*

Paragraph 2 of the Article, provides that a Contracting State may not tax a permanent establishment of an enterprise of the other Contracting State less favorably than an enterprise of that first-mentioned State that is carrying on the same activities.

The fact that a U.S. permanent establishment of an enterprise of Malta is subject to U.S. tax only on income that is attributable to the permanent establishment, while a U.S. corporation engaged in the same activities is taxable on its worldwide income is not, in itself, a sufficient difference to provide different treatment for the permanent establishment. There are cases, however, where the two enterprises would not be similarly situated and differences in treatment may be warranted. For instance, it would not be a violation of the non-discrimination protection of paragraph 2 to require the foreign enterprise to provide information in a reasonable manner that may be different from the information requirements imposed on a resident enterprise, because information may not be as readily available to the Internal Revenue Service from a foreign as from a domestic enterprise. Similarly, it would not be a violation of paragraph 2 to impose penalties on persons who fail to comply with such a requirement (see, e.g., sections 874(a) and 882(c)(2)). Further, a determination that income and expenses have been attributed or allocated to a permanent establishment in conformity with the principles of Article 7 (Business Profits) implies that the attribution or allocation was not discriminatory.

Section 1446 of the Code imposes on any partnership with income that is effectively connected with a U.S. trade or business the obligation to withhold tax on amounts allocable to a foreign partner. In the context of the Convention, this obligation applies with respect to a share of the partnership income of a partner resident in Malta, and attributable to a U.S. permanent establishment. There is no similar obligation with respect to the distributive shares of U.S. resident partners. It is understood, however, that this distinction is not a form of discrimination within the meaning of paragraph 2 of the Article. No distinction is made between U.S. and non-U.S. partnerships, since the law requires that partnerships of both U.S. and non-U.S. domicile withhold tax in respect of the partnership shares of non-U.S. partners. Furthermore, in distinguishing between U.S. and non-U.S. partners, the requirement to withhold on the non-U.S. but not the U.S. partner's share is not discriminatory taxation, but, like other withholding on nonresident aliens, is merely a reasonable method for the collection of tax from persons who are not continually present in the United States, and as to whom it otherwise may be difficult for the United States to enforce its tax jurisdiction. If tax has been over-withheld, the partner can, as in other cases of over-withholding, file for a refund.

### *Paragraph 3*

Paragraph 3 makes clear that the provisions of paragraphs 1 and 2 do not obligate a Contracting State to grant to a resident of the other Contracting State any tax allowances, reliefs, etc., that it grants to its own residents on account of their civil status or family responsibilities. Thus, if a sole proprietor who is a resident of Malta has a permanent establishment in the United States, in assessing income tax on the profits attributable to the permanent establishment, the United States is not obligated to allow to the resident of Malta the personal allowances for himself and his family that he would be permitted to take if the permanent establishment

were a sole proprietorship owned and operated by a U.S. resident, despite the fact that the individual income tax rates would apply.

*Paragraph 4*

Paragraph 4 prohibits discrimination in the allowance of deductions. When a resident or an enterprise of a Contracting State pays interest, royalties or other disbursements to a resident of the other Contracting State, the first-mentioned Contracting State must allow a deduction for those payments in computing the taxable profits of the resident or enterprise as if the payment had been made under the same conditions to a resident of the first-mentioned Contracting State. Paragraph 4, however, does not require a Contracting State to give nonresidents more favorable treatment than it gives to its own residents. Consequently, a Contracting State does not have to allow nonresidents a deduction for items that are not deductible under its domestic law (for example, expenses of a capital nature).

The term “other disbursements” is understood to include a reasonable allocation of executive and general administrative expenses, research and development expenses and other expenses incurred for the benefit of a group of related persons that includes the person incurring the expense.

An exception to the rule of paragraph 4 is provided for cases where the provisions of paragraph 1 of Article 9 (Associated Enterprises), paragraph 7 of Article 11 (Interest) or paragraph 6 of Article 12 (Royalties) apply. All of these provisions permit the denial of deductions in certain circumstances in respect of transactions between related persons. Neither State is forced to apply the non-discrimination principle in such cases. The exception with respect to paragraph 7 of Article 11 would include the denial or deferral of certain interest deductions under Code section 163(j).

Paragraph 4 also provides that any debts of an enterprise of a Contracting State to a resident of the other Contracting State are deductible in the first-mentioned Contracting State for purposes of computing the capital tax of the enterprise under the same conditions as if the debt had been contracted to a resident of the first-mentioned Contracting State. Even though, for general purposes, the Convention covers only income taxes, under paragraph 7 of this Article, the nondiscrimination provisions apply to all taxes levied in both Contracting States, at all levels of government. Thus, this provision may be relevant for both States. The other Contracting State may have capital taxes and in the United States such taxes frequently are imposed by local governments.

*Paragraph 5*

Paragraph 5 requires that a Contracting State not impose more burdensome taxation or connected requirements on an enterprise of that State that is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State than the taxation or connected requirements that it imposes on other similar enterprises of that first-mentioned Contracting State. For this purpose it is understood that “similar” refers to similar activities or ownership of the enterprise.

This rule, like all non-discrimination provisions, does not prohibit differing treatment of entities that are in differing circumstances. Rather, a protected enterprise is only required to be treated in the same manner as other enterprises that, from the point of view of the application of the tax law, are in substantially similar circumstances both in law and in fact. The taxation of a distributing corporation under section 367(e) on an applicable distribution to foreign shareholders does not violate paragraph 5 of the Article because a foreign-owned corporation is not similar to a domestically-owned corporation that is accorded non-recognition treatment under sections 337 and 355.

For the reasons given above in connection with the discussion of paragraph 2 of the Article, it is also understood that the provision in section 1446 of the Code for withholding of tax on non-U.S. partners does not violate paragraph 5 of the Article.

It is further understood that the ineligibility of a U.S. corporation with nonresident alien shareholders to make an election to be an "S" corporation does not violate paragraph 5 of the Article. If a corporation elects to be an S corporation, it is generally not subject to income tax and the shareholders take into account their pro rata shares of the corporation's items of income, loss, deduction or credit. (The purpose of the provision is to allow an individual or small group of individuals the protections of conducting business in corporate form while paying taxes at individual rates as if the business were conducted directly.) A nonresident alien does not pay U.S. tax on a net basis, and, thus, does not generally take into account items of loss, deduction or credit. Thus, the S corporation provisions do not exclude corporations with nonresident alien shareholders because such shareholders are foreign, but only because they are not net-basis taxpayers. Similarly, the provisions exclude corporations with other types of shareholders where the purpose of the provisions cannot be fulfilled or their mechanics implemented. For example, corporations with corporate shareholders are excluded because the purpose of the provision to permit individuals to conduct a business in corporate form at individual tax rates would not be furthered by their inclusion.

Finally, it is understood that paragraph 5 does not require a Contracting State to allow foreign corporations to join in filing a consolidated return with a domestic corporation or to allow similar benefits between domestic and foreign enterprises.

#### *Paragraph 6*

Paragraph 6 of the Article confirms that no provision of the Article will prevent either Contracting State from imposing the branch profits tax described in paragraph 8 of Article 10 (Dividends).

#### *Paragraph 7*

As noted above, notwithstanding the specification of taxes covered by the Convention in Article 2 (Taxes Covered) for general purposes, for purposes of providing nondiscrimination protection this Article applies to taxes of every kind and description imposed by a Contracting State or a political subdivision or local authority thereof. Customs duties are not considered to be taxes for this purpose.

*Relationship to Other Articles*

The saving clause of paragraph 4 of Article 1 (General Scope) does not apply to this Article by virtue of the exceptions in paragraph 5(a) of Article 1. Thus, for example, a U.S. citizen who is a resident of Malta may claim benefits in the United States under this Article.

Nationals of a Contracting State may claim the benefits of paragraph 1 regardless of whether they are entitled to benefits under Article 22 (Limitation on Benefits), because that paragraph applies to nationals and not residents. They may not claim the benefits of the other paragraphs of this Article with respect to an item of income unless they are generally entitled to treaty benefits with respect to that income under a provision of Article 22.

## ARTICLE 25 (MUTUAL AGREEMENT PROCEDURE)

This Article provides the mechanism for taxpayers to bring to the attention of competent authorities issues and problems that may arise under the Convention. It also provides the authority for cooperation between the competent authorities of the Contracting States to resolve disputes and clarify issues that may arise under the Convention and to resolve cases of double taxation not provided for in the Convention. The competent authorities of the two Contracting States are identified in paragraph 1(g) of Article 3 (General Definitions).

*Paragraph 1*

This paragraph provides that where a resident of a Contracting State considers that the actions of one or both Contracting States will result in taxation that is not in accordance with the Convention he may present his case to the competent authority of either Contracting State. This rule is more generous than in most treaties, which generally allow taxpayers to bring competent authority cases only to the competent authority of their country of residence, or citizenship/nationality. Under this more generous rule, a U.S. permanent establishment of a corporation resident in Malta that faces inconsistent treatment in the two countries would be able to bring its request for assistance to the U.S. competent authority. If the U.S. competent authority can resolve the issue on its own, then the taxpayer need never involve the Maltese competent authority. Thus, the rule provides flexibility that might result in greater efficiency.

Although the typical cases brought under this paragraph will involve economic double taxation arising from transfer pricing adjustments, the scope of this paragraph is not limited to such cases. For example, a taxpayer could request assistance from the competent authority if one Contracting State determines that the taxpayer has received deferred compensation taxable at source under Article 14 (Income from Employment), while the taxpayer believes that such income should be treated as a pension that is taxable only in his country of residence pursuant to Article 17 (Pensions, Social Security, Annuities, Alimony, and Child Support).

It is not necessary for a person requesting assistance first to have exhausted the remedies provided under the national laws of

the Contracting States before presenting a case to the competent authorities, nor does the fact that the statute of limitations may have passed for seeking a refund preclude bringing a case to the competent authority. Unlike the OECD Model, no time limit is provided within which a case must be brought.

*Paragraph 2*

Paragraph 2 sets out the framework within which the competent authorities will deal with cases brought by taxpayers under paragraph 1. It provides that, if the competent authority of the Contracting State to which the case is presented judges the case to have merit, and cannot reach a unilateral solution, it shall seek an agreement with the competent authority of the other Contracting State pursuant to which taxation not in accordance with the Convention will be avoided.

Any agreement is to be implemented even if such implementation otherwise would be barred by the statute of limitations or by some other procedural limitation, such as a closing agreement. Paragraph 2, however, does not prevent the application of domestic-law procedural limitations that give effect to the agreement (e.g., a domestic-law requirement that the taxpayer file a return reflecting the agreement within one year of the date of the agreement).

Where the taxpayer has entered a closing agreement (or other written settlement) with the United States before bringing a case to the competent authorities, the U.S. competent authority will endeavor only to obtain a correlative adjustment from Malta. See Rev. Proc. 200654, 2006-49 I.R.B. 1035, § 7.05. Because, as specified in paragraph 2 of Article 1 (General Scope), the Convention cannot operate to increase a taxpayer's liability, temporal or other procedural limitations can be overridden only for the purpose of making refunds and not to impose additional tax.

*Paragraph 3*

Paragraph 3 authorizes the competent authorities to resolve difficulties or doubts that may arise as to the application or interpretation of the Convention. The paragraph includes a non-exhaustive list of examples of the kinds of matters about which the competent authorities may reach agreement. This list is purely illustrative; it does not grant any authority that is not implicitly present as a result of the introductory sentence of paragraph 3.

The competent authorities may, for example, agree to the same allocation of income, deductions, credits or allowances between an enterprise in one Contracting State and its permanent establishment in the other or between related persons. These allocations are to be made in accordance with the arm's length principle underlying Article 7 (Business Profits) and Article 9 (Associated Enterprises). Agreements reached under these subparagraphs may include agreement on a methodology for determining an appropriate transfer price, on an acceptable range of results under that methodology, or on a common treatment of a taxpayer's cost sharing arrangement.

As indicated in subparagraph 3(c), the competent authorities also may agree to settle a variety of conflicting applications of the Con-

vention. They may agree to settle conflicts regarding the characterization of particular items of income, the characterization of persons, the application of source rules to particular items of income, the meaning of a term, or the timing of an item of income.

The competent authorities also may agree as to advance pricing arrangements. They also may agree as to the application of the provisions of domestic law regarding penalties, fines, and interest in a manner consistent with the purposes of the Convention.

Since the list under paragraph 3 is not exhaustive, the competent authorities may reach agreement on issues not enumerated in paragraph 3 if necessary to avoid double taxation. For example, the competent authorities may seek agreement on a uniform set of standards for the use of exchange rates. Agreements reached by the competent authorities under paragraph 3 need not conform to the internal law provisions of either Contracting State.

Finally, paragraph 3 authorizes the competent authorities to consult for the purpose of eliminating double taxation in cases not provided for in the Convention and to resolve any difficulties or doubts arising as to the interpretation or application of the Convention. This provision is intended to permit the competent authorities to implement the treaty in particular cases in a manner that is consistent with its expressed general purposes. It permits the competent authorities to deal with cases that are within the spirit of the provisions but that are not specifically covered. An example of such a case might be double taxation arising from a transfer pricing adjustment between two permanent establishments of a third-country resident, one in the United States and one in Malta. Since no resident of a Contracting State is involved in the case, the Convention does not apply, but the competent authorities nevertheless may use the authority of this Article to prevent the double taxation of income.

#### *Paragraph 4*

Paragraph 4 authorizes the competent authorities to increase any dollar amounts referred to in the Convention to reflect economic and monetary developments. This refers only to Article 16 (Entertainers and Sportsmen); Article 20 (Students and Trainees) separately instructs the competent authorities to adjust the exemption amount for students and trainees in accordance with specified guidelines. The rule under paragraph 4 is intended to operate as follows: if, for example, after the Convention has been in force for some time, inflation rates have been such as to make the \$20,000 exemption threshold for entertainers unrealistically low in terms of the original objectives intended in setting the threshold, the competent authorities may agree to a higher threshold without the need for formal amendment to the treaty and ratification by the Contracting States. This authority can be exercised, however, only to the extent necessary to restore those original objectives. This provision can be applied only to the benefit of taxpayers (i.e., only to increase thresholds, not to reduce them).

#### *Paragraph 5*

Paragraph 5 provides that the competent authorities may communicate with each other for the purpose of reaching an agree-



ment. This makes clear that the competent authorities of the two Contracting States may communicate without going through diplomatic channels. Such communication may be in various forms, including, where appropriate, through face-to-face meetings of representatives of the competent authorities.

*Treaty termination in relation to competent authority dispute resolution*

A case may be raised by a taxpayer after the Convention has been terminated with respect to a year for which a treaty was in force. In such a case the ability of the competent authorities to act is limited. They may not exchange confidential information, nor may they reach a solution that varies from that specified in its law.

*Triangular competent authority solutions*

International tax cases may involve more than two taxing jurisdictions (e.g., transactions among a parent corporation resident in country A and its subsidiaries resident in countries B and C). As long as there is a complete network of treaties among the three countries, it should be possible, under the full combination of bilateral authorities, for the competent authorities of the three States to work together on a three-sided solution. Although country A may not be able to give information received under Article 26 (Exchange of Information and Administrative Assistance) from country B to the authorities of country C, if the competent authorities of the three countries are working together, it should not be a problem for them to arrange for the authorities of country B to give the necessary information directly to the tax authorities of country C, as well as to those of country A. Each bilateral part of the trilateral solution must, of course, not exceed the scope of the authority of the competent authorities under the relevant bilateral treaty.

*Relationship to Other Articles*

This Article is not subject to the saving clause of paragraph 4 of Article 1 (General Scope) by virtue of the exceptions in subparagraph 5(a) of that Article. Thus, rules, definitions, procedures, etc. that are agreed upon by the competent authorities under this Article may be applied by the United States with respect to its citizens and residents even if they differ from the comparable Code provisions. Similarly, as indicated above, U.S. law may be overridden to provide refunds of tax to a U.S. citizen or resident under this Article. A person may seek relief under Article 25 regardless of whether he is generally entitled to benefits under Article 22 (Limitation on Benefits). As in all other cases, the competent authority is vested with the discretion to decide whether the claim for relief is justified.

ARTICLE 26 (EXCHANGE OF INFORMATION AND ADMINISTRATIVE ASSISTANCE)

This Article provides for the exchange of information and administrative assistance between the competent authorities of the Contracting States.

*Paragraph 1*

The obligation to obtain and provide information to the other Contracting State is set out in Paragraph 1. The information to be exchanged is that which may be relevant for carrying out the provisions of the Convention or the domestic laws of the United States or of the other Contracting State concerning taxes of every kind applied at the national level. This language incorporates the standard in 26 U.S.C. Section 7602 which authorizes the IRS to examine “any books, papers, records, or other data which may be relevant or material.” (Emphasis added.) In *United States v. Arthur Young & Co.*, 465 U.S. 805, 814 (1984), the Supreme Court stated that the language “may be” reflects Congress’s express intention to allow the IRS to obtain “items of even potential relevance to an ongoing investigation, without reference to its admissibility.” (Emphasis in original.) However, the language “may be” would not support a request in which a Contracting State simply asked for information regarding all bank accounts maintained by residents of that Contracting State in the other Contracting State, or even all accounts maintained by its residents with respect to a particular bank.

Exchange of information with respect to each State’s domestic law is authorized to the extent that taxation under domestic law is not contrary to the Convention. Thus, for example, information may be exchanged with respect to a covered tax, even if the transaction to which the information relates is a purely domestic transaction in the requesting State and, therefore, the exchange is not made to carry out the Convention. An example of such a case is provided in paragraph 8(b) of the OECD Commentary: a company resident in one Contracting State and a company resident in the other Contracting State transact business between themselves through a third-country resident company. Neither Contracting State has a treaty with the third State. To enforce their internal laws with respect to transactions of their residents with the third-country company (since there is no relevant treaty in force), the Contracting States may exchange information regarding the prices that their residents paid in their transactions with the third-country resident.

Paragraph 1 clarifies that information may be exchanged that relates to the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. Thus, the competent authorities may request and provide information for cases under examination or criminal investigation, in collection, on appeals, or under prosecution.

The taxes covered by the Convention for purposes of this Article constitute a broader category of taxes than those referred to in Article 2 (Taxes Covered). Exchange of information is authorized with respect to taxes of every kind imposed by a Contracting State at the national level. Accordingly, information may be exchanged with respect to U.S. estate and gift taxes, excise taxes or, with respect to Malta, value added taxes.

Information exchange is not restricted by paragraph 1 of Article 1 (General Scope). Accordingly, information may be requested and provided under this article with respect to persons who are not residents of either Contracting State. For example, if a third-coun-

try resident has a permanent establishment in Malta, and that permanent establishment engages in transactions with a U.S. enterprise, the United States could request information with respect to that permanent establishment, even though the third-country resident is not a resident of either Contracting State. Similarly, if a third-country resident maintains a bank account in Malta, and the Internal Revenue Service has reason to believe that funds in that account should have been reported for U.S. tax purposes but have not been so reported, information can be requested from Malta with respect to that person's account, even though that person is not the taxpayer under examination.

Although the term "United States" does not encompass U.S. possessions for most purposes of the Convention, Section 7651 of the Code authorizes the Internal Revenue Service to utilize the provisions of the Internal Revenue Code to obtain information from the U.S. possessions pursuant to a proper request made under Article 26. If necessary to obtain requested information, the Internal Revenue Service could issue and enforce an administrative summons to the taxpayer, a tax authority (or a government agency in a U.S. possession), or a third party located in a U.S. possession.

*Paragraph 2*

Paragraph 2 provides assurances that any information exchanged will be treated as secret, subject to the same disclosure constraints as information obtained under the laws of the requesting State. Information received may be disclosed only to persons, including courts and administrative bodies, involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of the of appeals in relation to, the taxes covered by the Convention. The information must be used by these persons in connection with the specified functions. Information may also be disclosed to legislative bodies, such as the tax-writing committees of Congress and the Government Accountability Office, engaged in the oversight of the preceding activities. Information received by these bodies must be for use in the performance of their role in overseeing the administration of U.S. tax laws. Information received may be disclosed in public court proceedings or in judicial decisions.

Paragraph 2 also provides that the competent authority of the Contracting State that receives information under this Article may, with the written consent of the other Contracting State, make that information available to be used for other purposes allowed under the provisions of an existing mutual legal assistance treaty between the Contracting States that allows for the exchange of tax information.

*Paragraph 3*

Paragraph 3 provides that the obligations undertaken in paragraphs 1 and 2 to exchange information do not require a Contracting State to carry out administrative measures that are at variance with the laws or administrative practice of either State. Nor is a Contracting State required to supply information not obtainable under the laws or administrative practice of either State,

or to disclose trade secrets or other information, the disclosure of which would be contrary to public policy.

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

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

#### *Paragraph 4*

Paragraph 4 provides that when information is requested by a Contracting State in accordance with this Article, the other Contracting State is obligated to obtain the requested information as if the tax in question were the tax of the requested State, even if that State has no direct tax interest in the case to which the request relates. In the absence of such a paragraph, some taxpayers have argued that paragraph 3(a) prevents a Contracting State from requesting information from a bank or fiduciary that the Contracting State does not need for its own tax purposes. This paragraph clarifies that paragraph 3 does not impose such a restriction and that a Contracting State is not limited to providing only the information that it already has in its own files.

#### *Paragraph 5*

Paragraph 5 provides that a Contracting State may not decline to provide information because that information is held by financial institutions, nominees or persons acting in an agency or fiduciary capacity. Thus, paragraph 5 would effectively prevent a Contracting State from relying on paragraph 3 to argue that its domestic bank secrecy laws (or similar legislation relating to disclosure of financial information by financial institutions or intermediaries) override its obligation to provide information under paragraph 1. This paragraph also requires the disclosure of information regarding the beneficial owner of an interest in a person, such as the identity of a beneficial owner of bearer shares.

#### *Paragraph 6*

Paragraph 6 provides that the requesting State may specify the form in which information is to be provided (e.g., depositions of witnesses and authenticated copies of original documents). The intention is to ensure that the information may be introduced as evidence in the judicial proceedings of the requesting State. The requested State should, if possible, provide the information in the form requested to the same extent that it can obtain information

in that form under its own laws and administrative practices with respect to its own taxes.

*Paragraph 7*

Paragraph 7 provides that the requested State shall allow representatives of the applicant State to enter the requested State to interview individuals and examine books and records with the consent of the persons subject to examination.

*Paragraph 8*

Paragraph 8 states that the competent authorities of the Contracting States may develop an agreement upon the mode of application of the Article. The article authorizes the competent authorities to exchange information on a routine basis, on request in relation to a specific case, or spontaneously. It is contemplated that the Contracting States will utilize this authority to engage in all of these forms of information exchange, as appropriate.

The competent authorities may also agree on specific procedures and timetables for the exchange of information. In particular, the competent authorities may agree on minimum thresholds regarding tax at stake or take other measures aimed at ensuring some measure of reciprocity with respect to the overall exchange of information between the Contracting States.

*Treaty effective dates and termination in relation to exchange of information*

Once the Convention is in force, the competent authority may seek information under the Convention with respect to a year prior to the entry into force of the Convention. Even if an earlier Convention with more restrictive provisions, or even no Convention, was in effect during the years in which the transaction at issue occurred, the exchange of information provisions of the Convention apply. In that case, the competent authorities have available to them the full range of information exchange provisions afforded under this Article. Paragraph 3 of Article 28 (Entry into Force) confirms this understanding with respect to the effective date of the Article.

A tax administration may also seek information with respect to a year for which a treaty was in force after the treaty has been terminated. In such a case the ability of the other tax administration to act is limited. The treaty no longer provides authority for the tax administrations to exchange confidential information. They may only exchange information pursuant to domestic law or other international agreement or arrangement.

ARTICLE 27 (MEMBERS OF DIPLOMATIC MISSIONS AND CONSULAR POSTS)

This Article confirms that any fiscal privileges to which diplomatic or consular officials are entitled under general provisions of international law or under special agreements will apply notwithstanding any provisions to the contrary in the Convention. The agreements referred to include any bilateral agreements, such as consular conventions, that affect the taxation of diplomats and consular officials and any multilateral agreements dealing with these

issues, such as the Vienna Convention on Diplomatic Relations and the Vienna Convention on Consular Relations. The U.S. generally adheres to the latter because its terms are consistent with customary international law.

The Article does not independently provide any benefits to diplomatic agents and consular officers. Article 19 (Government Service) does so, as do Code section 893 and a number of bilateral and multilateral agreements. In the event that there is a conflict between the Convention and international law or such other treaties, under which the diplomatic agent or consular official is entitled to greater benefits under the latter, the latter laws or agreements shall have precedence. Conversely, if the Convention confers a greater benefit than another agreement, the affected person could claim the benefit of the tax treaty.

Pursuant to subparagraph 5(b) of Article 1 (General Scope), the saving clause of paragraph 4 of Article 1 does not apply to override any benefits of this Article available to an individual who is neither a citizen of the United States nor has immigrant status in the United States.

#### ARTICLE 28 (ENTRY INTO FORCE)

This Article contains the rules for bringing the Convention into force and giving effect to its provisions.

##### *Paragraph 1*

Paragraph 1 provides for the ratification of the Convention by both Contracting States according to their constitutional and statutory requirements. Instruments of ratification shall be exchanged as soon as possible.

In the United States, the process leading to ratification and entry into force is as follows: Once a treaty has been signed by authorized representatives of the two Contracting States, the Department of State sends the treaty to the President who formally transmits it to the Senate for its advice and consent to ratification, which requires approval by two-thirds of the Senators present and voting. Prior to this vote, however, it generally has been the practice for the Senate Committee on Foreign Relations to hold hearings on the treaty and make a recommendation regarding its approval to the full Senate. Both Government and private sector witnesses may testify at these hearings. After the Senate gives its advice and consent to ratification of the treaty, an instrument of ratification is drafted for the President's signature. The President's signature completes the process in the United States.

##### *Paragraph 2*

Paragraph 2 provides that the Convention will enter into force upon the exchange of instruments of ratification. The date on which a treaty enters into force is not necessarily the date on which its provisions take effect. Paragraph 2, therefore, also contains rules that determine when the provisions of the treaty will have effect.

Under paragraph 2(a), the Convention will have effect with respect to taxes withheld at source (principally dividends, interest and royalties) for amounts paid or credited on or after the first day

of the second month following the date on which the Convention enters into force. For example, if instruments of ratification are exchanged on April 25 of a given year, the withholding rates specified in paragraph 2 of Article 10 (Dividends) would be applicable to any dividends paid or credited on or after June 1 of that year. This rule allows the benefits of the withholding reductions to be put into effect as soon as possible, without waiting until the following year. The delay of one to two months is required to allow sufficient time for withholding agents to be informed about the change in withholding rates. If for some reason a withholding agent withholds at a higher rate than that provided by the Convention (perhaps because it was not able to re-program its computers before the payment is made), a beneficial owner of the income that is a resident of the other Contracting State may make a claim for refund pursuant to section 1464 of the Code.

For all other taxes, paragraph 2(b) specifies that the Convention will have effect for any taxable period beginning on or after January 1 of the year following entry into force.

*Paragraph 3*

As discussed under Article 26 (Exchange of Information), the powers afforded the competent authority under that article apply from the date of entry into force of the Convention, regardless of the taxable period to which the matter relates.

ARTICLE 29 (TERMINATION)

The Convention is to remain in effect indefinitely, unless terminated by one of the Contracting States in accordance with the provisions of Article 29. The Convention may be terminated at any time after the year in which the Convention enters into force. If notice of termination is given, the provisions of the Convention with respect to withholding at source will cease to have effect after the expiration of a period of 6 months beginning with the delivery of notice of termination. For other taxes, the Convention will cease to have effect as of taxable periods beginning after the expiration of this 6 month period.

Article 29 relates only to unilateral termination of the Convention by a Contracting State. Nothing in that Article should be construed as preventing the Contracting States from concluding a new bilateral agreement, subject to ratification, that supersedes, amends or terminates provisions of the Convention without the six-month notification period.

Customary international law observed by the United States and other countries, as reflected in the Vienna Convention on Treaties, allows termination by one Contracting State at any time in the event of a "material breach" of the agreement by the other Contracting State.





## TREATIES

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TUESDAY, NOVEMBER 10, 2009

U.S. SENATE,  
COMMITTEE ON FOREIGN RELATIONS,  
*Washington, DC.*

The committee met, pursuant to notice, at 9 a.m., in room SD-419, Dirksen Senate Office Building, Hon. Edward E. Kaufman, presiding.

Present: Senator Kaufman.

### OPENING STATEMENT OF HON. EDWARD E. KAUFMAN, U.S. SENATOR FROM DELAWARE

Senator KAUFMAN. I'll say it again, good morning.

VOICES. Good morning.

Senator KAUFMAN. Today the committee will take up five treaties: two protocols that amend our existing tax treaties with France and New Zealand, a new tax treaty with Malta, a bilateral investment treaty with Rwanda, and an international convention on plant genetic resources for food and agriculture.

The France and New Zealand tax protocols reflect our ongoing efforts to modernize existing tax treaties to conform to current United States policy. In addition to reducing or eliminating source-country taxation on certain dividends and royalties, both protocols update the existing antiabuse and information exchange provisions enforced with France and New Zealand.

These changes will help guard against nonresidents improperly benefiting from the treaties, and will facilitate the exchange of tax information, which will assist in detecting tax evasion.

The France protocol also provides for mandatory arbitration, similar in many respects to recent treaties with Canada, Germany, and Belgium.

The proposed tax treaty with Malta recognizes the significant changes that Malta has made to its domestic tax law in response to United States concerns that led to the termination of our original tax agreement with Malta in 1997. This proposed convention, like the protocols, generally follows the 2006 U.S. Model Tax Treaty; however, it deviates from the model in certain areas, including where deemed necessary to provide enhanced protection against treaty-shopping.

I would note that critical stakeholders, such as the U.S. Chamber of Commerce, the National Association of Manufacturers, the National Foreign Trade Council, are all on record in strong support of early ratification of the three tax treaties before us today.

Moving from tax policy to investment policy, the United States-Rwanda Bilateral Investment Treaty is the first such agreement concluded between the United States and a sub-Saharan African country since 1998. Our negotiators engaged Rwanda in this endeavor in recognition of the Rwanda Government's efforts to open its economy, improve its business climate, and embrace trade and investment as a means to boost economic development and alleviate poverty.

In 2008 and 2009, less than two decades after the genocide from which Rwanda still strives to recover, Rwanda led the world in the World Bank's review of doing business reforms, a first for a sub-Saharan economy. We anticipate that the Rwanda BIT will reinforce the government's economic reform program and facilitate continued progress in the rebuilding and recovery that has taken place since the 1994 genocide. We would also hope to see similar openness in the expansion of political space in Rwanda.

Last, by joining the International Plant Genetic Resources Treaty, the United States will ensure we continue to play a leading role in the conservation of critical plant resources for future generations. Recent experience with dramatic price increases and global food scarcity demonstrate the need to preserve and enhance access to these resources. By joining this convention, the United States will secure access to valuable plant genetic resources and information from other countries, a service which the Department of Agriculture is already authorized to provide at no cost. This treaty enjoys support from a broad range of stakeholders, including the American Sea Trade Association, the Biotechnology Industry Organization, Intellectual Property Owners Association, and the National Farms Unit.

We are fortunate to have four—and I really mean that—four excellent witnesses today: Kerri-Ann Jones, the Assistant Secretary of State for the Bureau of Oceans and International Environmental and Scientific Affairs; Manal Corwin, international tax counsel for the Treasury Department; Wes Scholz, the Director of the Office of Investment Affairs at the State Department; and Thomas Barthold, chief of staff of the Joint Committee on Taxation. We will start with tax treaties, so I'll turn first to Ms. Corwin and next to Mr. Barthold; after that, we'll take up Rwanda, BIT, and the Plant Genetics Treaty.

Ms. Corwin.

**STATEMENT OF MANAL CORWIN, INTERNATIONAL TAX  
COUNSEL, DEPARTMENT OF TREASURY**

Ms. CORWIN. Thank you, Senator Kaufman. I appreciate the opportunity to appear today to recommend, on behalf of the administration, favorable action on three tax treaties pending before this committee. We appreciate the committee's interest in these treaties and in the U.S. tax treaty program overall.

This administration is committed to eliminating barriers to cross-border trade and investment and preventing offshore tax evasion.

Tax treaties play a vital role in supporting both of these objectives. Tax treaties facilitate cross-border investment and provide greater certainty to taxpayers regarding their potential tax liability in foreign jurisdictions. They do so by allocating taxing rights between jurisdictions, minimizing incidences of double taxation, and ensuring that U.S. taxpayers are not subject to discriminatory treatment.

Tax treaties also play an important role in preventing tax evasion. A key element of U.S. tax treaties is exchange of information between tax authorities. Because access to information from other countries is critically important to the full and fair enforcement of U.S. tax laws, information exchange is a top priority for the United States tax treaty program.

The treaties before the committee today—with France, Malta, and New Zealand—serve to further our tax treaty program goals of facilitating cross-border trade and investment and preventing fiscal evasion. We urge the committee and the Senate to take prompt and favorable action on these agreements, which I will now describe very briefly.

The proposed protocol with France is the second protocol amending the current tax convention with France signed in 1994. The most significant provisions in this agreement relate to the taxation of dividends and royalties, the adoption of mandatory arbitration to facilitate the resolution of disputes between the United States and French revenue authorities, and provisions to prevent treaty abuse and provide for full exchange of information for tax purposes.

More specifically, the proposed protocol eliminates the source country withholding tax on certain intercompany dividends and on all royalty payments. The proposed protocol also makes a number of changes to the limitation on benefits article of the current convention, which is designed to protect against abuses of the treaty by third-country residents.

Finally, the proposed protocol provides for mandatory binding arbitration of certain cases that have not been resolved by the competent authorities within a specified period. The mandatory binding arbitration provision included in the protocol with France is similar to provisions in our current treaties with Canada, Germany, and Belgium, which this committee and the Senate approved over the last 3 years. However, in recognition of the helpful comments offered by this committee with respect to the arbitration provisions in the prior agreements, the arbitration provision in the French protocol differs from the prior provisions in three key respects.

First, the proposed arbitration rule with France permits the taxpayers whose tax liabilities are affected by the arbitration proceeding to submit a position paper directly to the arbitration panel.

Second, the proposed rule prohibits employees of the tax administrations of either the United States or France from being appointed as members to the arbitration panel.

Finally, the proposed rule does not establish a hierarchy of legal authorities for treaty interpretation.

We are hopeful that these three modifications adequately address the concerns previously raised by this committee. We look forward to continuing to work with this committee to make arbitration an

effective tool in promoting fair and expeditious resolution of tax treaty disputes.

The proposed income tax convention with Malta reestablishes a prior tax treaty relationship between Malta and the United States. In 1996, the United States terminated its tax treaty with Malta, originally signed in 1980, because of concerns related to abuses of the treaty by third-country residents and inadequate exchange of information. Since 1996, Malta has made important changes to its domestic law in order to make a treaty possible again. Most notably, Malta repealed its bank secrecy rules so that it could agree to a "full exchange of information" provision in the proposed treaty.

The proposed convention with Malta is generally consistent with the current U.S. Model Income Tax Treaty. To take into account special features of Malta's domestic law, however, the proposed treaty contains robust rules to prevent so-called "treaty shopping." In particular, the proposed treaty includes a strict and comprehensive "limitation on benefits" article and provides for a positive withholding tax rate on dividends, royalties, and interest.

Finally, the proposed convention provides for the full exchange of information.

The proposed protocol with New Zealand is the first protocol amending our current tax treaty, which entered into force in 1983. The proposed protocol makes a number of changes to the current convention, including eliminating the source-country withholding tax on certain dividends and on all royalties. The proposed protocol also updates the "limitation on benefits" article, bringing into line with the U.S. Model Treaty.

Let me conclude by thanking you for the opportunity to appear before the committee to discuss the administration's efforts with respect to the three agreements under consideration. We thank the committee members and staff for devoting time and attention to the review of these agreements, and we are grateful for the assistance and cooperation of the staff of the Joint Committee on Taxation. I also would like to acknowledge and express my appreciation for the work done on the proposed treaties by the teams at Treasury, the Internal Revenue Service, and the State Department.

On behalf of the administration, we urge the committee and the Senate to take prompt and favorable action on the agreements before you today. And I'm happy to respond to any questions you may have.

[The prepared statement of Ms. Corwin follows:]

PREPARED STATEMENT OF MANAL CORWIN, INTERNATIONAL TAX COUNSEL,  
DEPARTMENT OF TREASURY, WASHINGTON, DC

Chairman Kerry, Ranking Member Lugar, and distinguished members of the committee, I appreciate the opportunity to appear today to recommend, on behalf of the administration, favorable action on three tax treaties pending before this committee. We appreciate the committee's interest in these treaties and in the U.S. tax treaty network overall.

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

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

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

The treaties before the committee today with France, Malta, and New Zealand serve to further the goals of our tax treaty network. The treaties with France and New Zealand would modify existing tax treaty relationships, to increase benefits in some instances and to eliminate inappropriate benefits in others. The tax treaty with Malta would reestablish a tax treaty relationship between our two countries that was interrupted when the United States terminated a prior tax treaty with Malta signed in 1980. We urge the committee and the Senate to take prompt and favorable action on all of these agreements.

Before talking about the pending treaties in more detail, I would like to discuss some more general tax treaty matters.

#### PURPOSES AND BENEFITS OF TAX TREATIES

Tax treaties set out clear ground rules that govern tax matters relating to trade and investment between the two countries.

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

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

In addition to reducing potential double taxation, tax treaties also reduce potential "excessive" taxation by reducing withholding taxes that are imposed at source. Under U.S. law, payments to non-U.S. persons of dividends and royalties as well as certain payments of interest are subject to withholding tax equal to 30 percent of the gross amount paid. Most of our trading partners impose similar levels of withholding tax on these types of income. This tax is imposed on a gross, rather than net, amount. Because the withholding tax does not take into account expenses incurred in generating the income, the taxpayer that bears the burden of withholding tax frequently will be subject to an effective rate of tax that is significantly higher than the tax rate that would be applicable to net income in either the source

or residence country. The taxpayer may be viewed, therefore, as suffering excessive taxation. Tax treaties alleviate this burden by setting maximum levels for the withholding tax that the treaty partners may impose on these types of income or by providing for exclusive residence-country taxation of such income through the elimination of source-country withholding tax. Because of the excessive taxation that withholding taxes can represent, the United States seeks to include in tax treaties provisions that substantially reduce or eliminate source-country withholding taxes.

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

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

In addition to these core provisions, tax treaties include provisions dealing with more specialized situations, such as rules coordinating the pension rules of the tax systems of the two countries or addressing the treatment of Social Security benefits and alimony and child-support payments in the cross-border context (the Social Security Administration separately negotiates and administers bilateral totalization agreements). These provisions are becoming increasingly important as more individuals move between countries or otherwise are engaged in cross-border activities. While these matters may not involve substantial tax revenue from the perspective of the two governments, rules providing clear and appropriate treatment are very important to the affected taxpayers.

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

#### TAX TREATY NEGOTIATING PRIORITIES AND PROCESS

The United States has a network of 59 income tax treaties covering 67 countries. This network covers the vast majority of foreign trade and investment of U.S. businesses and investors. In establishing our negotiating priorities, our primary objective is the conclusion of tax treaties that will provide the greatest benefit to the United States and to U.S. taxpayers. We communicate regularly with the U.S. business community and the Internal Revenue Service, seeking their input regarding the areas in which treaty network expansion and improvement efforts should be focused and seeking information regarding practical problems encountered under particular treaties and particular tax regimes.

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

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

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

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

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

In other cases, a tax treaty may be inappropriate because the potential treaty partner is not willing to agree to particular treaty provisions that are needed to address real tax problems that have been identified by U.S. businesses operating there. If the potential treaty partner is unwilling to provide meaningful benefits in a tax treaty, investors would find no relief, and accordingly there would be no merit to entering into such an agreement. The Treasury Department would not enter into a tax treaty that did not provide benefits to investors or which could be construed as an indication to future potential treaty partners that we would settle for a tax treaty with inferior terms.

Sometimes a potential treaty partner insists on provisions the United States will not agree to, such as providing a U.S. tax credit for investment in the foreign country (so-called "tax sparing"). With other countries there simply may not be the type of cross-border tax issues that are best resolved by treaty. For example, if a country does not impose significant income taxes, there is little possibility of double taxation of cross-border income, and an agreement that focuses exclusively on the exchange of tax information (so called "tax information exchange agreements" or TIEAs) may be the most appropriate agreement.

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

#### CONSIDERATION OF ARBITRATION

Tax treaties cannot facilitate cross-border investment and provide a more stable investment environment unless the treaty is effectively implemented by the tax

administrations of the two countries. Under our tax treaties, when a U.S. taxpayer becomes concerned about implementation of the treaty, the taxpayer can bring the matter to the U.S. competent authority who will seek to resolve the matter with the competent authority of the treaty partner. The competent authorities will work cooperatively to resolve genuine disputes as to the appropriate application of the treaty.

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

The first U.S. tax agreement that contemplated arbitration was the United States-Germany income tax treaty signed in 1989. Tax treaties with some other countries, including Mexico and the Netherlands, incorporate authority for establishing voluntary binding arbitration procedures based on the provision in the prior United States-Germany treaty (although, these provisions have never been implemented). Although we believe that the presence of these voluntary arbitration provisions may have provided some limited incentive to reaching mutual agreements, it has become clear that the ability to enter into voluntary arbitration does not always provide sufficient incentive to resolve problem cases in a timely fashion.

Over the past few years, we have carefully considered and studied various types of mandatory arbitration procedures that could be used as part of the competent authority mutual agreement process. In particular, we examined the experience of countries that adopted mandatory binding arbitration provisions with respect to tax matters. Many of them report that the prospect of impending mandatory arbitration creates a significant incentive to compromise before commencement of the process. Based on our review of the U.S. experience with arbitration in other areas of the law, the success of other countries with arbitration in the tax area, and the overwhelming support of the business community, we concluded that mandatory binding arbitration as the final step in the competent authority process can be an effective and appropriate tool to facilitate mutual agreement under U.S. tax treaties.

One of the treaties before the committee, the Protocol with France, includes a type of mandatory arbitration provision that in general terms is similar to provisions in our current treaties with Canada, Germany, and Belgium, which this committee and the Senate have approved over the last 3 years.

In the typical competent authority mutual agreement process, a U.S. taxpayer presents its problem to the U.S. competent authority and participates in formulating the position the U.S. competent authority will take in discussions with the treaty partner. Under the arbitration provision proposed in the France protocol, as in the similar provisions that are now part of our treaties with Canada, Germany, and Belgium, if the competent authorities cannot resolve the issue within 2 years, the competent authorities must present the issue to an arbitration board for resolution, unless both competent authorities agree that the case is not suitable for arbitration. The arbitration board must resolve the issue by choosing the position of one of the competent authorities. That position is adopted as the agreement of the competent authorities and is treated like any other mutual agreement (i.e., one that has been negotiated by the competent authorities) under the treaty.

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

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



In negotiating the arbitration rule in the proposed Protocol with France, we took into account concerns expressed by this committee over certain aspects of the arbitration rules with Canada, Germany, and Belgium. Accordingly, the proposed arbitration rule with France differs from its predecessors in three key respects. First, recognizing the committee's instructions in its report on the Canada protocol that future arbitration rules should provide a mechanism for taxpayer input in the arbitration process, the proposed rule with France allows the taxpayers who presented the original case that is subjected to arbitration to submit a Position Paper directly to the arbitration panel. Second, the rule on the proposed France Protocol disallows a competent authority from appointing an employee from its own tax administration to the arbitration board. Finally, the rule in the proposed France Protocol does not prescribe a hierarchy of legal authorities that the arbitration panel will use in making its decision. Thus, customary international law rules on treaty interpretation will apply. The new protocol amending our tax treaty with Switzerland, signed in September 2009, also contains an arbitration rule that is substantially the same as the rule in the proposed France Protocol. The administration hopes to transmit the Switzerland protocol to the Senate for its advice and consent as soon as possible.

Arbitration is a growing and developing field, and there are many forms of arbitration from which to choose. We intend to continue to study other arbitration provisions and to monitor the performance of the provisions in the agreements with Canada, Belgium, and Germany, as well as the performance of the provision in the agreement with France, if ratified. As requested by the Senate in its approval of the protocol with Canada in 2008, the Internal Revenue Service has published the administrative procedures necessary to implement the arbitration rules with Germany and Belgium, although to date no tax disputes with either country has been submitted to arbitration. The development of arbitration procedures are still under discussion with the Canadian tax authorities.

We look forward to continuing to work with the committee to make arbitration an effective tool in promoting the fair and expeditious resolution of treaty disputes. The committee's comments made with respect to the arbitration provisions with Canada, Germany, and Belgium have been very helpful and will continue to inform future negotiations of arbitration provisions.

#### DISCUSSION OF PROPOSED TREATIES

I now would like to discuss the three tax treaties that have been transmitted for the Senate's consideration. We have submitted a Technical Explanation of each treaty that contains detailed discussions of the provisions of each treaty. These Technical Explanations serve as the Treasury Department's official guide to each tax treaty.

##### *France*

The proposed Protocol with France was signed in Paris on January 13, 2009, and is the second protocol of amendment to the current tax Convention with France, signed in 1994. The most significant provisions in this agreement relate to the taxation of dividends and royalties, the adoption of mandatory arbitration to facilitate the resolution of disputes between the United States and French revenue authorities, and provisions to prevent treaty abuse and provide for full exchange of information for tax purposes. The Protocol also makes a number of necessary updates to the current Convention to better reflect French and U.S. domestic law.

The proposed Protocol makes a number of changes to the dividend article of the current Convention. The proposed Protocol eliminates the source-country withholding tax on many intercompany dividends. In general, a company receiving a dividend must have a substantial interest in the distributing corporation for a 12-month period and meet special limitation on benefits provisions to qualify for the exemption from withholding tax. The proposed Protocol also updates the dividend article to incorporate policies reflected in the U.S. Model provision, such as those regarding regulated investment companies (RICs) and real estate investment trusts (REITs).

The proposed Protocol makes a significant change to the royalty article of the current Convention. The current Convention allows the source country to withhold on royalty payments to residents of the other treaty partner with respect to certain types of property, but limits the withholding rate to a maximum of 5 percent. The proposed Protocol eliminates source-country withholding on all royalty payments, bringing the Convention in line with the U.S. Model treaty.

The proposed Protocol makes a number of changes to the limitation on benefits article of the current Convention. It tightens the limitation on benefits rules applicable to publicly traded companies to ensure a closer nexus between the company and its residence country through regional trading of its shares or local management

and control. The proposed Protocol further tightens the limitation on benefits provision by including a so-called “triangular provision” adopted in many U.S. tax treaties. The rule is designed to prevent the use of structures including third-country branches to avoid both source- and residence-country taxation. Under the provision, the United States needs not allow full treaty benefits to a French enterprise with respect to certain income attributable to a permanent establishment of the French enterprise located in a third country if the income is not subject to a sufficient combined level of tax in both France and the third country.

The proposed Protocol updates the provision in the current Convention that preserves the U.S. right to tax certain former citizens also to cover certain former long-term residents to reflect changes in U.S. law.

As previously noted, the proposed Protocol provides for mandatory arbitration of certain cases that have not been resolved by the competent authority within a specified period, generally 2 years from the commencement of the case. A Memorandum of Understanding accompanying the Protocol sets forth rules and procedures for arbitration. The arbitration board must deliver a determination within 6 months of the appointment of the chair of the arbitration board, and the determination must either be the proposed resolution submitted by the United States or the proposed resolution submitted by France. The board’s determination has no precedential value and that the board shall not provide a rationale for its determination. As mentioned above, in response to concerns expressed by the Senate in the approval of prior agreements, the arbitration rule in the proposed Protocol differs from earlier arbitration provisions in some key respects. First, the proposed Protocol permits the concerned taxpayers to submit written Position Papers to the arbitration board. Second, under the proposed Protocol, the competent authority of a Contracting State may not appoint an employee of its tax administration to be a member of the arbitration board. Finally, the proposed protocol does not prescribe a hierarchy of legal authorities to which the arbitration board must adhere.

The proposed Protocol provides that the United States and France shall notify each other in writing, through diplomatic channels, when their respective constitutional and statutory requirements for entry into force of the proposed Protocol have been satisfied. The proposed Protocol will enter into force upon the date of receipt of the later of such notifications. For taxes withheld at source, it will have effect for amounts paid or credited on or after the first day of the January of the year in which the proposed Protocol enters into force. With respect to other taxes, the proposed Protocol will generally have effect for taxable years that begin on or after the first day of January next following the date on which the proposed Protocol enters into force.

#### *Malta*

The proposed income tax Convention and accompanying exchange of notes with Malta signed in Valletta on August 8, 2008, reestablishes a previous tax treaty relationship between Malta and the United States. The proposed Convention is generally consistent with the current U.S. Model income tax treaty and with treaties that the United States has with other countries, while incorporating special rules to take into account special features of Malta’s domestic tax law.

Under the proposed Convention, the United States may impose withholding taxes on cross-border portfolio dividend payments at a maximum rate of 15 percent. When the beneficial owner of the dividend is a company that directly owns at least 10 percent of the stock of the company paying the dividend, the United States may impose withholding tax at a maximum rate of 5 percent. The proposed Convention also incorporates rules provided in the U.S. Model tax treaty for certain classes of investment income. For example, dividends paid by RICs and REITs are subject to special rules to prevent the use of these entities to transform what is otherwise higher taxed income into lower taxed income.

The proposed Convention generally limits withholding taxes on cross-border interest and royalty payments to a maximum rate of 10 percent. The interest article of the proposed Convention also contains the U.S. Model rules regarding contingent interest and REMICs.

The proposed Convention limits the taxation by one country of the business profits of a resident of the other country. The source country’s right to tax such profits is generally limited to cases in which the profits are attributable to a permanent establishment located in that country.

Consistent with current U.S. tax treaty policy, the proposed Convention includes a comprehensive limitation on benefits article, which takes into account unique features of Malta’s tax system and is designed to deny treaty shoppers the benefits of the Convention. The proposed Convention provides for nondiscriminatory treatment by one country to residents and nationals of the other country. In addition, the pro-

posed Convention provides for the full exchange between the tax authorities of each country of information relevant to carrying out the provisions of the agreement or the domestic tax laws of either country. This will facilitate the enforcement of U.S. domestic tax rules. The proposed Convention provides that information exchanged pursuant to the Convention may, with the written consent of the country providing the information, be used for certain nontax purposes as permitted under the provisions of an existing mutual legal assistance treaty between the two countries that allows for the exchange of tax information.

The proposed Convention provides that the United States and Malta shall exchange instruments of ratification when their respective applicable procedures for approval of the proposed Convention. The proposed Convention will enter into force upon the exchange of instruments of ratification. It will have effect, with respect to taxes withheld at source, for amounts paid or credited on or after the first day of the second month next following the date on which the proposed Convention enters into force and, with respect to other taxes, for taxable years beginning on or after the first day of January in the year following the date upon which the proposed Convention enters into force.

#### *New Zealand*

The proposed Protocol with New Zealand was signed in Washington on December 1, 2008, and amends the current tax Convention with New Zealand, which entered into force in 1983. The most significant provisions in this agreement relate to dividends, interest, royalties, taxation of income from personal services, antiabuse provisions, and exchange of information for tax purposes. The proposed Protocol deletes the current Convention's denial of treaty benefits to certain categories of U.S. citizens. The Protocol also makes a number of necessary updates to the current Convention to better reflect New Zealand and U.S. domestic law.

The proposed Protocol makes a number of changes to the dividend article of the current Convention. The proposed Protocol eliminates the source-country withholding tax on many intercompany dividends. In general, a company receiving a dividend must have a substantial interest in the distributing corporation for a 12-month period and meet special limitation on benefits provisions to qualify for the exemption from withholding tax. The proposed Protocol also updates the dividend article to incorporate policies reflected in the U.S. Model provision, such as those regarding dividends paid by RICs and REITs.

The proposed Protocol amends the interest article of the current Convention. The current Convention allows the source country to withhold on interest payments to unrelated banks and certain financial enterprises at a maximum of 10 percent. The proposed Protocol eliminates source-country withholding on these payments, provided, in the case of New Zealand, that the payer of the interest has paid New Zealand's "approved issuer levy" with respect to the interest. Moreover, the proposed Protocol secures the elimination of taxation by New Zealand on interest payments to unrelated U.S. banks and financial enterprises even if New Zealand changes the approved issuer levy regime in the future.

The proposed Protocol makes significant changes to the royalty article of the current Convention. The current Convention allows the source country to withhold on royalty payments with respect to certain types of property to residents of the other treaty partner, but limits the withholding rate to a maximum of 10 percent. The proposed Protocol lowers that maximum withholding rate on royalties to 5 percent. Additionally, the proposed Protocol amends current Convention's definition royalties by excluding from the definition payments for the rental of equipment and other, tangible personal property.

As a result, these rental payments will be subject to the same tax treatment as business income. These changes will bring the current tax Convention into closer alignment with U.S. Model tax treaty policy.

The proposed Protocol makes important changes to the taxation of individuals providing personal services. Under the current Convention, income from independent personal services (such as accounting, legal or consultancy services) may be taxed by the country in which the services are performed if the individual providing the services is present in that country for a period of 183 days or more. The proposed Protocol replaces this taxing right based on days of presence with the U.S. Model approach, which allows the country where the services are performed to tax the income only if the service provider has a fixed place of business in that country.

The proposed Protocol makes changes to the scope of benefits of the current Convention available to U.S. citizens. Under the current Convention, treaty benefits are only available to U.S. citizens who are also resident in the United States. The proposed Protocol eliminates the residency requirement and makes all U.S. citizens, wherever resident, eligible for treaty benefits. This broader application, which is

consistent with the U.S. Model tax treaty, is appropriate policy, because all U.S. citizens are subject to tax by the United States on their worldwide income (and thus deserving of the benefits of U.S. tax treaties) regardless of their place of residence.

The proposed Protocol replaces the limitation on benefits article of the current Convention with a provision that closely tracks the U.S. Model rule. It tightens the limitation on benefits rules applicable to publicly traded companies to ensure a closer nexus between the company and its residence country through trading of its shares on a local stock exchange or through local management and control. The proposed Protocol further tightens the limitation on benefits provision by including a so-called “triangular provision” adopted in many U.S. treaties. The rule is designed to prevent the use of structures including third-country branches to avoid both source- and residence-country taxation. Under the provision, the United States need not allow full treaty benefits to a New Zealand enterprise with respect to certain income attributable to a permanent establishment of the New Zealand enterprise located in a third country if the income is not subject to a sufficient combined level of tax in both New Zealand and the third country.

The proposed Protocol includes other antiabuse rules. It extends the provision in the current Convention that preserves the U.S. right to tax certain former citizens also to cover certain former long-term residents, and updates the provision to reflect changes in U.S. law. The proposed Protocol conforms the interest article in the current Convention to the U.S. Model treaty by including special contingent interest and real estate mortgage investment—conduit exceptions to the elimination of withholding tax on interest payments.

The proposed Protocol includes several other important administrative and technical amendments. Significantly, it updates the exchange of information provisions to specify the obligation to obtain and provide information held by financial institutions, and to otherwise reflect U.S. Model standards in this area.

The proposed Protocol provides that the United States and New Zealand shall notify each other in writing, through diplomatic channels, when their respective applicable procedures for ratification have been satisfied. The proposed Protocol will enter into force upon the date of the later of the required notifications. For taxes withheld at source, the proposed Protocol will have effect on the first day of the second month following the date of entry into force. With respect to other taxes, the Protocol will have effect in the United States for taxable periods starting on or after the first day of the January next following the date of entry into force. In New Zealand, the proposed Protocol will have effect with respect to other taxes for taxable periods beginning on or after the first day of April next following the date of entry into force.

#### TREATY PROGRAM PRIORITIES

A key continuing priority for the Treasury Department is updating the few remaining U.S. tax treaties that provide for significant withholding tax reductions but do not include the limitation on benefits provisions needed to protect against the possibility of treaty shopping. I am pleased to report that in this regard we have made significant progress. Most notably, in June 2009 we announced the conclusion of the negotiation of a new tax treaty with Hungary. The new Hungary treaty, which we hope to sign, soon will contain a comprehensive limitation on benefits provision that will ensure that only residents of the United States and Hungary will enjoy the benefits of the treaty. In addition, we recently concluded our second round of negotiations with Poland and plan to hold additional negotiations early next year.

Concluding agreements that provide for the full exchange of information, including information held by banks and other financial institutions, is another key priority of the Treasury Department. 2009 has been a year of fundamental change in transparency, as many secrecy jurisdictions announced their intentions to comply with the international standard of full information exchange. In this changing environment, the Treasury has made many key achievements, including the conclusion of protocols of amendment to the U.S. tax treaties with Switzerland and Luxembourg that provide for full exchange of information, including bank account information. The administration hopes to transmit these agreements to the Senate for its consideration as soon as possible. Moreover, in the near future we hope to commence or reinvigorate tax treaty negotiations with a number of our other trading partners with bank secrecy rules once those countries have eliminated all domestic law impediments to full exchange of information.

Beyond the two chief priorities of curbing treaty shopping and expanding exchange of information relationships, the Treasury Department continues to maintain a very active calendar of tax treaty negotiations. We have recently held formal

treaty negotiations with Colombia and Korea, and later this month will open formal negotiations with Israel.

CONCLUSION

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

On behalf of the administration, we urge the committee to take prompt and favorable action on the agreements before you today.

Senator KAUFMAN. Thank you.

Mr. Barthold.

**STATEMENT OF THOMAS A. BARTHOLD, CHIEF OF STAFF,  
JOINT COMMITTEE ON TAXATION**

Mr. BARTHOLD. Thank you, Mr. Chairman.

My name is Thomas A. Barthold. I'm the Chief of Staff for the Joint Committee on Taxation, and it's my pleasure to present the testimony of the staff of the Joint Committee on Taxation today concerning the proposed income tax treaty with Malta and the proposed tax protocols with France and New Zealand.

The Joint Committee Staff has prepared pamphlets covering the proposed treaty and protocols, including detailed descriptions of those documents, comparisons with the United States Model Income Tax Treaty, and detailed discussions of issues raised by the proposed treaty and protocols. I've provided the committee with a more detailed written statement, and I'll try to just briefly summarize a few high points from that material.

The proposed treaty and protocols generally follow the U.S. Model Treaty. However, there are some key differences, and I'd like to just briefly address three: treaty-shopping and the Malta treaty, about which Ms. Corwin spoke; binding arbitration and the French protocol, also discussed by my friend and colleague, Ms. Corwin; and the exchange of information provided under each document.

As was noted, in 1997 the United States had terminated its then-existing treaty with Malta, with the Treasury citing concerns over potential for treaty-shopping under the old treaty. Treaty-shopping is facilitated by a number of factors, among them weak limitation on benefits provisions of a treaty and certain favorable domestic law taxation of dividends, interest, and capital-gain income.

At that time, in the mid-1990s, the Treasury had also noted that Malta did not generally permit sharing of bank information with foreign tax authorities. Now, subsequent to joining the European Union, Malta has revised its law to permit sharing of bank information with tax authorities, and the proposed treaty would create a "limitation on benefits" provision more stringent than that of the U.S. model. It would also, as was noted, permit nonzero withholding rates on interest, dividends, and royalties.

However, Malta's internal law, which was seen a decade ago as potentially facilitating treaty-shopping, is largely unchanged. And for that reason, it may be beneficial to ask the Treasury Department more specifically what factors led it to conclude that the con-

cerns of a decade ago have been adequately addressed by the overall balance of the proposed treaty and the changes in internal law.

The proposed French protocol includes a requirement that disputes that the competent authorities of the two treaty countries are unable to resolve through consultation be settled by arbitration. The arbitration method is referred to as "last-best-offer arbitration," and, as was noted, the United States currently has three tax treaties, those with Belgium, Canada, and Germany, that have similar provisions for mandatory arbitration. Nevertheless, this remains a unique feature of the U.S. income tax treaty network, and there are some differences, as were noted by Ms. Corwin, of the arbitration as proposed under the French protocol and those of the three existing treaties.

By contrast with the tax treaties with Canada and Germany, but like that of the United States/Belgium treaty, the proposed protocol with France permits arbitration of any case involving the application of any article of the treaty, so long as the competent authorities have not agreed that the case is not suitable for arbitration. In the cases of Canada and Germany, mandatory arbitration is more prescribed.

As noted by Ms. Corwin, a second and an important contrast with the three existing treaties is that the proposed protocol with France allows a taxpayer whose case is in mandatory arbitration to submit a position paper to the arbitration board. This is an important new development, and the committee may wish to inquire both about the scope of mandatory arbitration—the comparison of the four cases just noted—and the opportunity for taxpayer participation. More broadly, as arbitration was included in the French protocol, but not in the protocol with New Zealand, for example, the committee might inquire whether this is to become a standard feature of future United States tax treaties, or if the Treasury Department has particular goals in selectively choosing certain countries with which it negotiates such provisions.

Also, I might note that, as the committee is aware, as a condition of ratifying the United States protocol with Canada just last year, the Senate required the Treasury Department to submit a report describing operation of the mandatory arbitration procedures under the Belgium, Canada, and Germany treaties. The committee may wish to consider whether it should require Treasury reporting to be expanded to encompass the arbitration proceedings that are proposed in the protocol with France.

Each of the proposed treaty and the protocols include "exchange of information" articles, again largely following the U.S. model. There is a unique feature in the Malta treaty, however. The proposed treaty permits the recipient of information exchanged under the treaty to use that information for purposes sanctioned by the United States/Malta treaty on certain aspects of mutual legal assistance in criminal matters, the so-called "MLAT."

The inclusion of a cross-reference to the MLAT in the proposed treaty is unique among U.S. income tax treaties providing for exchange of information. The committee may wish to explore how this new rule will be reconciled with domestic restrictions on disclosure of tax return information if Malta, for example, were to request permission to use the information for nontax purposes.

To the more general application of information exchange it is perhaps worth noting that automatic and specific information exchange, which are provided under the tax treaty and these protocols, may not always be useful. There are problems with automatic information exchange under existing U.S. tax treaties and the tax treaties of other countries, and these have included that information has not always been provided on a timely basis, the different treaty partners' tax reporting periods may differ from one another, the recipient country sometimes has even had difficulty translating the information into its own language, and then, sometimes the information is so voluminous as to not be beneficial to the tax authority.

So, the committee may wish to explore with the Treasury whether they foresee any practical impediments to the automatic information exchange provided with France, Malta, and New Zealand and the potential ease with which any impediments could be removed, and the likelihood that they, in fact, would be removed.

A specific problem with specific exchange of information has been that some treaty countries have declined to exchange information in response to specific requests intended to identify limited classes of purposes. The committee may wish to seek assurances, under the proposed treaty with Malta and the proposed protocols with France and New Zealand, that the treaty countries are required to exchange information in response to specific requests that are comparable to John Doe summonses under present law. This was an issue that has been in the news over the last half year in our dealings under the Swiss Treaty in the well-known *UBS* case.

I think those three main points are important highlights, and I'll conclude my oral testimony with that.

As always, I and my staff are happy to answer any questions that you or other members may have at this time or in the future.

[The prepared statement of Mr. Barthold follows:]

PREPARED STATEMENT OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION<sup>1</sup>

My name is Thomas A. Barthold. I am Chief of Staff of the Joint Committee on Taxation. It is my pleasure to present the testimony of the staff of the Joint Committee on Taxation today concerning the proposed income tax treaty with Malta and the proposed tax protocols with France and New Zealand.

OVERVIEW

As in the past, the Joint Committee staff has prepared pamphlets covering the proposed treaty and protocols. The pamphlets provide detailed descriptions of the proposed treaty and protocols, including comparisons with the United States Model Income Tax Convention of November 15, 2006 ("U.S. Model treaty"), which reflects preferred U.S. tax treaty policy, and with other recent U.S. tax treaties.<sup>2</sup> The pamphlets also provide detailed discussions of issues raised by the proposed treaty and protocols. We consulted with the Treasury Department and with the staff of

<sup>1</sup>This document may be cited as follows: Joint Committee on Taxation, Testimony of the Staff of the Joint Committee on Taxation Before the Senate Committee on Foreign Relations Hearing on the Proposed Tax Treaty with Malta and the Proposed Tax Protocols with France and New Zealand (JCX 0954 0909), November 10, 2009. This publication can also be found at <http://www.jct.gov/>.

<sup>2</sup>Joint Committee on Taxation, "Explanation of Proposed Income Tax Treaty Between the United States and Malta" (JCX-50-09), November 6, 2009; Joint Committee on Taxation, "Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and France" (JCX-49-09), November 6, 2009; Joint Committee on Taxation, "Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and New Zealand" (JCX-51-09), November 6, 2009.

your committee in analyzing the proposed treaty and protocols and in preparing the pamphlets.

The principal purposes of the treaty and protocols are to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country and to prevent avoidance or evasion of the taxes of the two countries. The proposed treaty and protocols also are intended to promote close economic cooperation between the treaty countries and to eliminate possible barriers to trade and investment caused by overlapping taxing jurisdictions of the treaty countries. As in other U.S. tax treaties, these objectives principally are achieved through each country's agreement to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other country.

The proposed treaty with Malta would restore an income tax treaty relationship that the United States terminated with effect in 1997. The proposed protocol with France would amend an existing tax treaty that was signed in 1994 and that was amended by a previous protocol signed in 2004. The proposed protocol with New Zealand would amend an existing tax treaty that was signed in 1982.

My testimony today will highlight some of the key features of the proposed treaty and protocols and certain issues that those agreements raise.

#### U.S. MODEL TREATY

As a general matter, U.S. Model tax treaties provide a framework for U.S. tax treaty policy and a starting point for tax treaty negotiations with our treaty partners. These models provide helpful information to taxpayers, the Congress, and foreign governments about U.S. policies on tax treaty matters. The present U.S. Model treaty incorporates important developments in U.S. income tax treaty policy that had been reflected in U.S. income tax treaties signed in the years immediately preceding the Model's publication in 2006. Treaties that the United States has negotiated since 2006 in large part follow the U.S. Model treaty. The proposed treaty and protocols that are the subject of this hearing are, accordingly, generally consistent with the provisions found in the U.S. Model treaty. There are, however, some key differences from the U.S. Model treaty that I will discuss.

#### MALTA: TREATY SHOPPING

##### *Limitation-on-benefits provisions*

Like the U.S. Model treaty, the proposed protocols with France and New Zealand and the proposed treaty with Malta include extensive limitation-on-benefits rules. Limitation-on-benefits provisions are intended to prevent third-country residents from benefiting inappropriately from a treaty that generally grants benefits only to residents of the two treaty countries. This practice is commonly referred to as "treaty shopping." A company may engage in treaty shopping by, for example, organizing a related treaty-country resident company that has no substantial presence in the treaty country. The third-country company may arrange, among other transactions, to have the related treaty-country company remove, or strip, income from the treaty country in a manner that reduces the overall tax burden on that income. Limitation-on-benefits rules may prevent these and other transactions by requiring that an individual or a company seeking treaty benefits have significant connections to a treaty country as a condition of eligibility for benefits.

The limitation-on-benefits rules of the proposed protocols with France and New Zealand are generally consistent with the rules of the U.S. Model treaty. The limitation-on-benefits rules of the proposed treaty with Malta, by contrast, depart in several significant respects from parallel rules of the U.S. Model treaty. These departures generally make the rules of the proposed treaty with Malta more restrictive than the U.S. Model treaty's limitation-on-benefits provision. For example, the departures include more restrictive tests, first, for determining whether a publicly traded company qualifies for treaty benefits and, second, for determining whether a nonpublicly traded company is eligible for treaty benefits based on the extent to which the company pays its gross income to persons who are not residents of either treaty country.

##### *Withholding tax rules*

The proposed treaty with Malta also departs from the U.S. Model treaty in its withholding tax rules for interest, royalties, and other income not covered by particular articles of the treaty. The U.S. Model treaty provides an exemption from source-country withholding tax on most payments of interest, royalties, and other income to a resident of the other treaty country. By contrast, the proposed treaty with Malta permits withholding at a 10-percent rate on these payments.



The proposed treaty with Malta is consistent with the U.S. Model treaty in its rules for dividend withholding tax, but these rules are less favorable to taxpayers than the dividend provisions of other recent U.S. tax treaties. Like the U.S. Model treaty, the proposed treaty with Malta permits imposition of source-country withholding tax at a 5-percent rate on dividends paid to a 10-percent-or-greater shareholder resident in the other treaty country and at a 15-percent rate on other dividends. The proposed protocol with France and many other recent U.S. tax treaties eliminate source-country withholding tax on dividends paid by an at least 80-percent-owned subsidiary to the parent corporation in the other treaty jurisdiction.

*Malta's domestic law*

The strict limitation-on-benefits rules and the less taxpayer-favorable withholding tax rules of the proposed treaty with Malta are intended to restrict treaty shopping that might otherwise be attractive because of features of Malta's internal tax laws. These features include, among others: (1) An exemption from Maltese corporate taxation for dividends received by a Malta corporation from certain foreign subsidiaries; (2) a corresponding exemption from Maltese corporate tax for gain from the sale of shares of these foreign subsidiaries; (3) the absence of Maltese withholding tax on dividend and interest payments to non-Maltese residents; and (4) an imputation system of corporate tax that has the effect of eliminating a shareholder-level tax on corporate profits.

*Appropriateness of entering into new treaty with Malta*

The previously mentioned U.S. termination of the prior income tax treaty with Malta was due in part to the Treasury Department's concern that Malta's internal tax law might have facilitated treaty shopping. At the time, Malta also did not generally permit sharing of bank information with foreign tax authorities. Malta has since joined the European Union ("EU"), implemented EU directives assuring mutual administrative assistance and compliance with international transparency norms, and revised its domestic laws to allow Maltese tax authorities to share bank information with foreign tax authorities. By contrast, the Maltese internal taxation rules that might have facilitated treaty shopping remain largely unchanged. To prevent possible treaty shopping, however, the proposed treaty includes the strict limitation-on-benefits and withholding tax provisions described above.

In light of the prior treaty history, your committee may wish to ask the Treasury Department about the factors that led it to conclude that it was now appropriate to enter into a new income tax treaty with Malta. Your committee may also wish to inquire whether the provisions of the proposed treaty and changes to Maltese domestic law, taken together, assuage the concerns that led the Treasury Department to terminate the prior treaty.

FRANCE: MANDATORY ARBITRATION

The proposed protocol with France broadly follows the U.S. Model treaty. The proposed protocol does, however, differ from the U.S. Model treaty in several provisions, including its requirement that disputes that the competent authorities of the two treaty countries are unable to resolve through consultation be settled by arbitration.

U.S. income tax treaties provide mutual agreement procedures authorizing the competent authorities of the treaty countries to cooperate to resolve disputes, clarify issues, and address cases of double taxation. The present tax treaty with France and other U.S. income tax treaties permit the competent authorities and the affected taxpayer to agree to voluntary arbitration of a case that the competent authorities cannot resolve by mutual agreement. The proposed protocol with France replaces this optional arbitration procedure with rules for mandatory arbitration of some unresolved disputes. Three U.S. tax treaties—those with Belgium, Canada, and Germany—now contain similar rules for mandatory arbitration. These rules are a departure from the U.S. Model treaty. The proposed treaty with Malta and the proposed protocol with New Zealand do not include provisions for mandatory arbitration of unresolved cases.

Although the mandatory arbitration provision of the proposed protocol with France is similar to the corresponding provisions of the U.S. tax treaties with Belgium, Canada, and Germany, there are two significant differences. First, by contrast with the U.S. tax treaties with Canada and Germany, but like the United States-Belgium treaty, the proposed protocol with France permits arbitration of any case involving the application of any article of the treaty so long as the competent authorities have not agreed that the case is not suitable for arbitration. The U.S. tax treaties with Canada and Germany provide mandatory arbitration of cases involving the application of only certain treaty articles. Second, by contrast with the treaties with Belgium, Canada, and Germany, the proposed protocol with France allows a

taxpayer whose case is in mandatory arbitration to submit a position paper to the arbitration board. Your committee may wish to inquire about both the scope of mandatory arbitration and the opportunity for taxpayer participation.

More broadly, your committee may wish to ask about the Treasury Department's intentions for future U.S. income tax treaties and protocols. Does the Treasury Department expect that mandatory arbitration provisions following the proposed protocol and the treaties with Belgium, Canada, and Germany will become a standard feature of future U.S. tax treaties, or will the Treasury Department be selective in choosing the countries with which it negotiates those provisions? If the Treasury Department expects mandatory arbitration to become a standard feature in future U.S. tax treaties, will the Treasury Department revise the U.S. Model treaty to include mandatory arbitration rules? If mandatory arbitration is not expected to be a part of all or most future U.S. income tax treaties, it may be useful to ask what criteria the Treasury Department will use to determine whether a particular treaty should include mandatory arbitration.

Your committee also is aware that as a condition of ratifying the U.S. protocol with Canada last year, the Senate required the Treasury Department to submit to the Joint Committee on Taxation and the Senate Finance Committee, among other information, a report describing the operation of the mandatory arbitration procedures of the treaties with Belgium, Canada, and Germany. This report must include information about the size and subject matter of cases before arbitration and the length of time of arbitration proceedings. This report must be provided within 60 days after a determination is reached in the 10th arbitration proceeding conducted under the U.S. treaty with Belgium, Canada, or Germany, and similar reports must be submitted annually for 5 years thereafter. These required reports will not include information about the operation of the mandatory arbitration procedures of the proposed protocol with France. Your committee may wish to consider whether the required Treasury reporting should be expanded to encompass arbitration proceedings under the proposed protocol with France.

#### EXCHANGE OF INFORMATION

The U.S. Model treaty and U.S. income tax treaties generally provide exchange of information rules requiring the competent authorities of the two treaty countries to exchange information that may be relevant for carrying out the treaties or the domestic laws of the treaty countries concerning all taxes imposed by a treaty country. The exchange of information article of the proposed protocol with New Zealand closely follows the information exchange rules of the U.S. Model treaty. The exchange of information articles of the proposed treaty with Malta and the proposed protocol with France largely follow the corresponding rules of the U.S. Model treaty but do differ in certain respects. The Joint Committee staff's pamphlets describe these differences and provide detailed overviews of the information exchange articles of the two proposed protocols and the proposed treaty. Here I wish to highlight issues related to the proposed treaty relationship with Malta and related to the effectiveness of information exchange under income tax treaties generally.

##### *Information exchange with Malta*

As described previously, the United States terminated its prior income tax treaty with Malta with effect in 1997. At the time, Malta did not generally permit sharing of bank information with foreign tax authorities. Malta has since joined the European Union and implemented EU directives concerning transparency and legal assistance. Last year, Malta revised its banking law to grant Maltese tax authorities access to bank information for the purpose of exchanging the information with tax authorities of other countries under information exchange agreements. Malta has entered into 45 agreements that require exchange of information in compliance with standards set by the Organisation for Economic Co-operation and Development ("OECD"). Malta is now considered to have fully committed to the transparency standards of the OECD.

To the extent that there were perceived deficiencies in the former information exchange relationship with Malta that contributed to the decision to terminate the prior treaty, and to the extent that the United States may have little recent practical experience in cooperating with Malta on tax matters, your committee may wish to seek reassurances that any obstacles to effective information exchange have been eliminated.

The information exchange article of the proposed treaty with Malta includes one difference from the corresponding article of the U.S. Model treaty. The proposed treaty permits the recipient of information exchanged under the treaty to use that information for purposes sanctioned by the United States-Malta Treaty on Certain Aspects of Mutual Legal Assistance in Criminal Matters ("MLAT"). The Senate rati-

fied that treaty last year, but it has not yet entered into effect. The extent to which this deviation from the U.S. Model treaty is intended to expand the scope of permitted exchange of information is not clear. The inclusion of a cross-reference to the MLAT in the proposed treaty is unique among U.S. income tax treaties, although it is consistent with both the OECD Convention on Mutual Assistance in Tax Matters (in Article 4) and the 2005 OECD Model Convention on Income and on Capital (in Article 26). Your committee may wish to explore how this new rule is to be reconciled with domestic restrictions on disclosure of return information if Malta requests permission to use the information for nontax purposes.

*Effectiveness of information exchange*

The Joint Committee staff's pamphlets describe in detail several practical issues related to information exchange under income tax treaties. I will briefly note two issues here. First, automatic and specific information exchange under tax treaties, two of three broad methods of exchange of information, may not always be fully useful.<sup>3</sup> Under automatic exchange, the parties to a tax treaty typically enter into a memorandum of understanding to share, on an ongoing basis, information that is deemed consistently relevant to the tax administration of the other treaty country; the treaty countries are not required to specifically request this information from one another. The United States, for example, provides to its treaty partners information about U.S.-source income received by residents of those treaty countries. Specific exchange occurs when one treaty country provides information to the other treaty country in response to a request by the latter country for information that is relevant to an ongoing investigation of a particular tax matter.

Problems with automatic exchange under U.S. tax treaties and the tax treaties of other countries have included that information has not been provided on a timely basis; treaty countries' tax reporting periods have differed from one another; the recipient country has had difficulty translating information into its own language; and information flows have been voluminous. Your committee may wish to inquire about whether there are any practical impediments to automatic information exchange with France, Malta, and New Zealand and the ease with which any impediments could be removed and the likelihood that they would be removed.

One problem with specific exchange has been that some treaty countries have declined to exchange information in response to specific requests intended to identify limited classes of persons.<sup>4</sup> Your committee may wish to seek assurances that, under the proposed treaty with Malta and the proposed protocols with France and New Zealand, treaty countries are required to exchange information in response to specific requests that are comparable to John Doe summonses under domestic law.<sup>5</sup>

Second, the United States has been criticized for Federal and State rules that may facilitate attempts by foreign persons to evade their home country tax laws. One criticism is that the U.S. "know your customer" rules for financial institutions may be less strict than other countries in their requirements for the determination of beneficial owners of financial accounts. A second criticism has been that the entity formation laws of some U.S. States make it difficult for government officials to ascertain the identities of owners of entities. Your committee may wish to ask about the extent to which it may be appropriate to consider policy changes to ensure that the United States is able to respond effectively to information requests from its treaty partners.

<sup>3</sup>The other method of information exchange is spontaneous exchange. Spontaneous exchange occurs when one treaty country determines that information in its possession may be relevant to the other treaty country's tax administration and thus transmits the information to the other country.

<sup>4</sup>For example, a petition to enforce a John Doe summons served by the United States on UBS, AG was filed on February 21, 2009, accompanied by an affidavit of Barry B. Shoff, the U.S. competent authority for the United States-Switzerland income tax treaty. Paragraph 16 of that affidavit notes that Switzerland had traditionally taken the position that a specific request must identify the taxpayer. See *United States v. UBS AG*, Civil No. 09-20423 (S.D. Fla.). On August 19, 2009, after extensive negotiations between the Swiss and U.S. Governments, the United States and UBS announced that UBS had agreed to provide information on over 4,000 U.S. persons with accounts at UBS.

<sup>5</sup>Under a John Doe summons, the U.S. Internal Revenue Service ("IRS") asks for information to identify unnamed "John Doe" taxpayers. The IRS may issue a John Doe summons only with judicial approval, and judicial approval is given only if there is a reasonable basis to believe that taxes have been avoided and that the information sought pertains to an ascertainable group of taxpayers and is not otherwise available.

## ARTICLE-BY-ARTICLE SUMMARIES

The Joint Committee staff's pamphlets provide detailed article-by-article explanations of the proposed treaty and the two proposed protocols. Below is a summary of significant features of each agreement.

*Malta*

Like other U.S. tax treaties, the proposed treaty with Malta includes rules that limit each country's right, in specified situations, to tax income derived from its territory by residents of the other country. For example, the proposed treaty contains provisions under which each country generally agrees not to tax business income derived from sources within that country by residents of the other country unless the business activities in the taxing country are substantial enough to constitute a permanent establishment (Article 7). Similarly, the proposed treaty contains certain exemptions under which residents of one country performing personal services in the other country will not be required to pay tax in the other country unless their contact with the other country exceeds specified minimums (Articles 14 and 16). The proposed treaty also provides that pensions and other similar remuneration paid to a resident of one country may be taxed only by that country and only at the time and to the extent that a pension distribution is made (Articles 17 and 18).

The proposed treaty provides that dividends and certain gains derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles 10 and 13); however, the proposed treaty limits the rate of tax that the source country may impose on certain dividends paid to a resident of the other country. As described previously, these rules are consistent with the corresponding provisions of the U.S. Model treaty, but they represent a departure from the exemption from source-country withholding tax provided by several recent U.S. treaties and protocols for dividends paid by subsidiaries to parent corporations resident in the other treaty countries.

The proposed treaty's rule for Maltese taxation of Malta-source dividends paid to residents of the United States takes into account the Maltese imputation system of corporate tax. The rule provides that the tax that may be charged by Malta on dividends paid by a Maltese company to a U.S. resident is limited to the Maltese tax chargeable on the profits out of which the dividends are paid.

The proposed treaty generally limits the rate of source-country tax that may be imposed on interest arising in one treaty country (the source country) and beneficially owned by a resident of the other treaty so that it may not exceed 10 percent of the gross amount of the interest (Article 11). Similarly, the proposed treaty provides that a royalty payment arising in a treaty country and beneficially owned by a resident of the other treaty country may be subject to a source country tax of up to 10 percent of the gross amount of the royalty (Article 12). As described previously, these provisions differ from the corresponding rules of the U.S. Model treaty. The U.S. Model treaty provides an exemption from source-country tax for most interest and royalty payments beneficially owned by a resident of the other country.

Unlike the U.S. Model treaty, the proposed treaty permits limited source-country taxation of income not dealt with in other articles of the treaty. That income may be taxed by the source country at a rate not greater than 10 percent (Article 21). As described previously, the U.S. Model treaty, by contrast, exempts this income from source-country taxation.

In situations in which the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the proposed treaty generally provides for relief from the potential double taxation through the allowance by the country of residence of a tax credit for certain foreign taxes paid to the other country (Article 22).

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

The proposed treaty (Article 20) generally provides that students and business trainees who are residents of one treaty country and who visit the other treaty country (the host country) are exempt from host-country taxation on certain types of payments received from sources in their home country for their maintenance, education, or training.

The proposed treaty provides authority for the two countries to resolve disputes (Article 25) and exchange information (Article 26) in order to carry out the provisions of the proposed treaty. As noted above, unlike the U.S. Model treaty exchange of information rules, the proposed treaty permits the use of tax information received under the tax treaty for purposes that are consistent with the scope of the MLAT between the United States and Malta.

The proposed treaty also contains a detailed limitation-on-benefits provision to prevent the inappropriate use of the treaty by third-country residents (Article 22). This provision generally reflects the anti-treaty-shopping provisions included in the U.S. Model treaty and more recent U.S. income tax treaties, but, as was described previously, is more stringent in a number of respects.

The provisions of the proposed treaty generally take effect on or after the first day of January following the date that the proposed treaty enters into force. With respect to withholding taxes (principally on dividends, interest, and royalties), the provisions of the proposed treaty take 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.

#### *France*

The proposed protocol with France makes changes to Article 4 (Resident) of the present treaty that in general make the rules conform more closely to the rules of other recent U.S. income tax treaties and protocols. Among other changes, the proposed protocol provides a special rule for French qualified partnerships and includes rules for fiscally transparent entities, which are entities that are not subject to tax at the entity level, that are similar to rules found in other recent U.S. income tax treaties. One difference from recent U.S. treaties is the addition of a requirement that, when a fiscally transparent entity formed or organized outside the United States or France derives an item of income, profit, or gain from U.S. or French sources, the fiscally transparent entities rules apply only if the country in which the entity is organized has concluded with the treaty country from which the income, profit, or gain is derived an agreement including an exchange of information provision intended to prevent tax evasion.

The proposed protocol replaces Article 10 (Dividends) of the present treaty. The new article generally allows full residence-country taxation and limited source-country taxation of dividends. The proposed protocol retains both the generally applicable 15-percent maximum withholding rate and the reduced 5-percent maximum rate for dividends received by a company owning at least 10 percent of the dividend-paying company. As described previously, like several other recent treaties and protocols, the proposed protocol provides for a zero rate of withholding tax on certain dividends received by a parent company from a subsidiary that is at least 80-percent owned by the parent. As in the present treaty, special rules apply to dividends received from a regulated investment company, a real estate investment trust, and a *société d'investissement à capital variable*; under the proposed protocol, these rules are extended to a *"société d'investissement immobilier cotée"* and a *"société de placement à prépondérance immobilière à capital variable."*

Article 12 (Royalties) of the present treaty is revised to provide that royalties arising in a treaty country (the source country) and beneficially owned by a resident of the other treaty country are exempt from taxation in the source country. Under the present treaty, the source country may impose up to a 5-percent withholding tax on gross royalty payments.

The proposed protocol makes conforming changes to Article 13 (Capital Gains) to reflect revisions made to Article 12 (Royalties). It also updates Article 17 (Artists and Sportsmen) to reflect the fact that the French currency is now the euro.

The proposed protocol clarifies that the exclusive source-country tax rule of Article 18 (Pensions) for payments arising under the social security legislation or similar legislation of one of the treaty countries to a resident of the other treaty country applies, in the case of payments arising under France's social security legislation, to payments made not only to residents of the United States, but also to citizens of the United States who are residents of France. Accordingly, notwithstanding the saving clause of paragraph 2 of Article 29 (Miscellaneous Provisions), the United States may not tax French social security payments made to a U.S. citizen resident in France.

Article 22 (Other Income) of the present treaty is replaced with a new article that conforms to the corresponding U.S. Model treaty provision. The article generally assigns taxing jurisdiction over income not dealt with in the other articles of the treaty to the residence country of the beneficial owner of the income.

The proposed protocol switches the order of two paragraphs of Article 24 (Relief from Double Taxation), clarifies that companies that are French residents may elect

to be taxed on a worldwide basis subject to a credit in lieu of applying the general exemption system in France to foreign business income, and makes several conforming changes.

The proposed protocol changes cross-references that Article 25 (Non-Discrimination) makes to provisions of Articles 10 (Dividends) and 12 (Royalties). These changes in cross-references reflect the proposed protocol's renumbering of certain paragraphs of Articles 10 and 12.

As described previously, the proposed protocol changes the voluntary arbitration procedure of Article 26 (Mutual Agreement Procedure) of the treaty to a mandatory arbitration procedure that is sometimes referred to as "last best offer" arbitration, in which each of the competent authorities proposes one and only one figure for settlement, and the arbitrator must select one of those figures as the award. Under the proposed protocol, unless a taxpayer or other "concerned person" (in general, a person whose tax liability is affected by the arbitration determination) does not accept the arbitration determination, it is binding on the treaty countries with respect to the case. A mandatory and binding arbitration procedure is included in the U.S. income tax treaties with Belgium, Canada, and Germany.

Mutual administrative assistance is modernized under the proposed protocol. The proposed protocol replaces Article 27 (Exchange of Information) of the present treaty with rules that conform closely to the U.S. Model treaty. The proposed rules generally provide that the two competent authorities will exchange such information as may be relevant in carrying out the provisions of the domestic laws of the United States and France concerning taxes imposed at a national level, to the extent the taxation under those laws is not contrary to the treaty. The proposed protocol's information exchange article deviates from the U.S. Model treaty's article in its conditions under which entry into a treaty country's sovereign territory is permitted. The proposed protocol requires that a treaty country permit representatives of the other treaty country enter its territory to interview a taxpayer or to examine a taxpayer's books and records if the taxpayer has consented. This rule is narrower than the corresponding rules of the U.S. Model treaty because the proposed protocol's rule does not permit entry for interviewing or examining the books and records of consenting third parties.

Article 28 (Assistance in Collection) of the present treaty is modified to remove an obsolete reference to former paragraph 4 of Article 10 (Dividends).

The proposed protocol amends Article 29 (Miscellaneous Provisions) of the present treaty, updating the saving clause to provide that France may tax entities that have their place of effective management in France, and which are subject to tax in France, notwithstanding the new fiscally transparent entity provision in Article 4 (Resident). It also updates the definition of former citizen and long-term residents to conform with the changes to section 877 of the Code and makes conforming changes to other paragraphs in Article 29. The proposed protocol adds a new rule to Article 29 that payments made by French Government agencies to lawful permanent residents of the United States will be taxable only in the United States.

As described previously, Article 30 (Limitation on Benefits) of the present treaty is replaced with a new article that reflects the anti-treaty-shopping provisions included in the U.S. Model treaty and more recent U.S. income tax treaties. The new rules are intended to prevent the indirect use of the treaty by persons who are not entitled to its benefits solely by reason of residence in France or the United States.

The proposed protocol modifies Article 32 (Provisions for Implementation) of the present treaty to delete obsolete references to former paragraph 4(i) of Article 10 (Dividends) and former paragraph 8 of Article 30 (Limitation on Benefits).

Finally, Article XVI of the proposed protocol provides for the entry into force of the proposed protocol. The treaty countries will notify each other in writing when their respective constitutional and statutory requirements for entry into force of the protocol have been satisfied. The proposed protocol will enter into force on the date of receipt of the latter of such notifications. For withholding taxes, the proposed protocol has effect with respect to amounts paid or credited on or after January 1st of the calendar year in which the proposed protocol enters into force. For all other taxes, the proposed protocol has effect for taxes imposed for tax periods beginning on or after January 1st of the year immediately after the date on which the proposed protocol enters into force. With respect to the binding arbitration rules of Article 26 (Mutual Agreement Procedures), the proposed protocol is effective for cases under consideration by the competent authorities as of the date the proposed protocol enters into force and cases that come under consideration thereafter.

*New Zealand*

Articles I (General Scope), II (Taxes Covered), III (General Definitions) and X (Independent Personal Services) of the proposed protocol with New Zealand generally update the provision of the present treaty to conform to the U.S. Model treaty.

The proposed protocol replaces the definition of “resident of a Contracting State” in Article 4 (Residence) of the present treaty with one that is identical to the definition in the U.S. Model treaty. The proposed protocol’s definition of a resident of a Contracting State reverses an exclusion from the definition in the present treaty for a person who is subject to tax in a treaty country by reason of that person’s citizenship but who is not a resident of that country. Consequently, under the proposed protocol, a nonresident citizen of the United States may (subject to the article’s other rules) be treated as a resident of the United States. The proposed protocol also conforms to the U.S. Model treaty’s two tie-breaker rules for determining the residence of an individual who otherwise would be a resident of both treaty countries. Accordingly, residence under these tie-breaker rules is determined based on the country of which the individual is a national, rather than, as under the present treaty, on the individual’s country of citizenship.

The proposed protocol adds new paragraphs 8 and 9 to Article 7 (Business Profits) of the present treaty. New paragraph 8, like the U.S. Model treaty, provides that business profits may be attributable to a permanent establishment (and therefore may be taxable in the source country) even if the payment of the income is deferred until after the permanent establishment has ceased to exist. New paragraph 9 differs from the U.S. Model and OECD Model treaties, and specifically addresses New Zealand law relating to trusts. It provides that (1) if a fiscally transparent entity, or trustee, has a permanent establishment in one treaty country, and (2) a resident of the other treaty country is beneficially entitled to a share of profits from a business carried on by the entity or trustee through a permanent establishment in the first country, then the beneficial owner is treated as carrying on the business through the permanent establishment.

The proposed protocol replaces Article 10 (Dividends) of the present treaty with a new article that generally allows full residence-country taxation and limited source-country taxation of dividends. The proposed protocol retains the generally applicable maximum rate of withholding at source of 15 percent, but also adds a reduced 5-percent maximum rate for dividends received by a company owning at least 10 percent of the voting power of dividend-paying company. Like several other recent treaties and protocols, the proposed protocol also provides for a zero rate of withholding tax on certain dividends received by a parent company from a subsidiary that is at least 80-percent owned by the parent. The proposed protocol adds special rules that apply to dividends received from regulated investment companies and real estate investment trusts which are similar to provisions included in other recent treaties and protocols.

The proposed protocol replaces Article 11 (Interest) of the present treaty with a new article that retains source-country taxation, of interest at a maximum withholding rate of 10 percent, but allows a special zero rate of withholding for certain financial institutions and governmental entities.

The proposed protocol revises Article 12 (Royalties) of the present treaty. It provides that royalties arising in a treaty country (the source country) and beneficially owned by a resident of the other treaty country may be subject to a source country tax of up to 5 percent. This is a reduction from the 10-percent rate provided in the present treaty, but any source-country taxation of royalties remains above the exemption provided in the U.S. Model treaty.

The proposed protocol makes two modifications to Article 13 (Alienation of Property). The proposed protocol makes a conforming change to reflect the elimination of Article 14 (Independent Personal Services) of the present treaty in a manner consistent with the OECD Model treaty. Additionally, to avoid double taxation, the proposed protocol updates the present treaty to allow U.S. individuals who expatriate to New Zealand (who are required to recognize taxable gain on a deemed sale of all of their property under section 877A of the Code) to get a step up in tax basis for New Zealand tax purposes by treating the property deemed sold as immediately repurchased at its fair market value.

The proposed protocol replaces Article 16 (Limitation on Benefits) of the present treaty with a new article that reflects the anti-treaty-shopping provisions included in the U.S. Model treaty and more recent U.S. income tax treaties. The new rules are intended to prevent the indirect use of the treaty by persons who are not entitled to its benefits solely by reason of residence in New Zealand or the United States.

The proposed protocol makes certain conforming changes to Article 22 (Relief from Double Taxation) of the present treaty to reflect changes by the proposed protocol to Article 2 (Taxes Covered). The proposed protocol also deletes the last sentence of paragraph 2 of Article 22 of the present treaty. The deleted sentence provides that dividends received from a U.S. company by a New Zealand company that owns at least 10 percent of the paid-up share capital of the U.S. company (being dividends that would be exempt from New Zealand tax under New Zealand law at the time of the signing of the present treaty) are exempt from New Zealand tax.

The proposed protocol replaces the nondiscrimination rules of Article 23 of the present treaty with new rules that are similar to the nondiscrimination provisions of the U.S. Model treaty and other recent U.S. income tax treaties. These rules generally forbid each treaty country from discriminating against nationals of the other country by imposing on those nationals more burdensome taxes than it would impose on its own comparably situated nationals in the same circumstances. Similarly, neither treaty 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. The nondiscrimination provision does not include the U.S. Model treaty rule which provides that the nondiscrimination rules apply to taxes of every kind and description imposed by a treaty country or by a political subdivision or local authority of that treaty country. Accordingly, the nondiscrimination rules apply only to taxes covered by the present treaty (as modified by the proposed protocol) and not, for example, to U.S. State and local taxes.

The proposed protocol does not change the provisions of Article 24 (Mutual Agreement Procedure) of the treaty. Thus, the treaty, as modified by the proposed protocol, does not include a mandatory arbitration procedure similar to the rules of the proposed protocol with France and the treaties with Belgium, Canada, and Germany.

The proposed protocol replaces Article 25 (Exchange of Information) of the present treaty with rules that conform closely to the U.S. Model treaty. The proposed rules generally provide that the two competent authorities will exchange such information as may be relevant in carrying out the provisions of the domestic laws of the United States and New Zealand concerning taxes imposed at a national level, to the extent the taxation under those laws is not contrary to the treaty, as modified by the proposed protocol. It provides—for the first time—for mutual assistance in the collection of tax debts between the United States and New Zealand. Such assistance is limited to tax debts that arise from improperly granted treaty benefits.

The proposed protocol replaces paragraph 1 of the protocol to the present treaty, which was signed on the same day as the treaty. Under the proposed protocol, New Zealand is required to consult with the United States for purposes of providing the same treatment on a reciprocal basis if (1) it enters into a double taxation treaty with any country (and not just with an OECD member) and (2) that treaty limits the withholding tax rates on interest or royalties (but not dividends) to a rate lower than the one provided for in the treaty with the United States.

Under the provisions of Article XVI, the proposed protocol enters into force on the date of the later of the notifications. The relevant date is the date on the second of the notification documents, and not the date on which the second notification is delivered to the other treaty country. Generally, the proposed protocol is effective on a prospective basis. However, the competent authority provisions under Article 26 (Exchange of Information) are effective retroactively to taxable periods preceding the entry into force of the proposed protocol.

#### CONCLUSION

These provisions and issues are all discussed in more detail in the Joint Committee staff pamphlets on the proposed treaty and protocols.

Senator KAUFMAN. Thank you.

Mr. Scholz.

#### **STATEMENT OF WESLEY SCHOLZ, DIRECTOR, OFFICE OF INVESTMENT AFFAIRS, BUREAU OF ECONOMIC, ENERGY, AND BUSINESS AFFAIRS, DEPARTMENT OF STATE**

Mr. SCHOLZ. Thank you, Senator Kaufman. It's a privilege to be here to testify before the Senate Foreign Relations Committee as the administration seeks advice and consent of the Senate to ratification of the United States-Rwanda Bilateral Investment Treaty.



Foreign investment is an important source of economic growth in the United States and around the globe. It improves productivity, provides good jobs, and spurs healthy competition. Foreign investment is a platform for U.S. exports. In 2007, 22 percent of U.S. exports of goods were shipped to foreign subsidiaries of U.S. firms.

Foreign investment can also be a powerful tool for economic development. BITs play an important role by establishing rules that protect the rights of investors abroad and provide market access for future U.S. investment.

Since the inception of the U.S. Bilateral Investment Treaty Program in the early 1980s, successive U.S. administrations have negotiated BITs with the objective of protecting U.S. investment abroad, encouraging the adoption of open, transparent, and non-discriminatory investment policies, and supporting the development of international legal standards consistent with these objectives.

The United States presently is a party to BITs with 40 countries. Five of these treaties are with sub-Saharan African countries, although the BIT with Rwanda is the first such treaty signed by the United States with a sub-Saharan African country in almost a decade.

The United States chose to negotiate a BIT with Rwanda, in part based on its strong economic reform program, which has helped to rebuild the Rwandan economy since the 1994 genocide. The Rwandan Government has opened its economy, improved its business climate, and embraced trade and investment as a means to boost economic development and help alleviate poverty.

In the World Bank's Doing Business 2010 Report, Rwanda was the world's most improved country for its record of business-related reforms, a first for a sub-Saharan African economy. Rwanda also maintains a consistent policy of attempting to combat corruption.

As the result of these reforms, foreign investors are increasingly giving Rwanda serious consideration as a destination for investment. According to our Embassy, United States-led investment in Rwanda is poised to grow from less than \$50 million pre-2008 to more than \$600 million in 3 to 5 years.

These improvements could increase access to energy significantly for Rwandans and their regional neighbors, expand the number of Rwandan university-educated students from the thousands to the tens of thousands, and provide low-cost green housing for middle-income Rwandans.

United States investment has the potential to change Rwanda's economic landscape and play a significant role in assisting Rwandan Government's efforts to become an economic hub for central Africa.

The Department of State and the Office of U.S. Trade Representative co-lead the negotiation of this treaty, with the participation of the Departments of Commerce and Treasury and other U.S. Government agencies. The treaty, which was signed on February 19, 2008, closely adheres to the text of the 2004 U.S. model. The treaty will complement Rwanda's reform efforts, help Rwanda attract more foreign investment that is vital to economic prosperity, and deepen our economic relationship with an important partner in Africa. It would also set a very positive example for others in the region.

Looking ahead, the administration is interested in exploring possibilities for new U.S. BITs in Africa. On August 5, at an event during the African Growth and Opportunity Act Forum in Nairobi, Secretary of State Clinton and U.S. Trade Representative Kirk announced that the United States would also start negotiations toward a Bilateral Investment Treaty with Mauritius. Mauritius is another partner in sub-Saharan Africa that has taken serious steps to enact reforms and improve its business climate. At that time, Secretary Clinton echoed President Obama's call to do more to promote investment in Africa and commented that the launch of negotiations with Mauritius is in keeping with our broader interest in engaging other potential partners in Africa.

In conclusion, the administration wishes to thank the committee for its consideration of the treaty, and we urge you to report it favorably to the full Senate for action.

I'd be happy to answer any of your questions.

[The prepared statement of Mr. Scholz follows:]

PREPARED STATEMENT OF WESLEY S. SCHOLZ, DIRECTOR, OFFICE OF INVESTMENT AFFAIRS, DEPARTMENT OF STATE, WASHINGTON, DC

Mr. Chairman, thank you for the opportunity to testify before the Foreign Relations Committee as the administration seeks advice and consent of the Senate to ratification of the United States-Rwanda Bilateral Investment Treaty (BIT).

Foreign investment is an important source of economic growth in the United States and around the globe. It improves productivity, provides good jobs, and spurs healthy competition. Foreign investment is a platform for U.S. exports. In 2007, 22 percent of U.S. goods exports were shipped to foreign subsidiaries of U.S. firms. Foreign investment can also be a powerful tool for economic development. BITs play an important role by establishing rules that protect the rights of U.S. investors abroad and provide market access for future U.S. investment. Since the inception of the U.S. BIT program in the early 1980s, successive U.S. administrations have negotiated BITs with the objective of protecting U.S. investment abroad, encouraging the adoption of open, transparent, and nondiscriminatory investment policies, and supporting the development of international legal standards consistent with these objectives. U.S. BITs build on the principles contained in earlier U.S. treaties of Friendship, Commerce, and Navigation. The United States presently is a party to BITs with 40 countries. Five of these treaties are with sub-Saharan African countries, although the BIT with Rwanda is the first such treaty signed by the United States with a sub-Saharan African country in almost a decade.<sup>1</sup>

The United States chose to negotiate a BIT with Rwanda in part based on its strong economic reform program, which has helped to rebuild the Rwandan economy since the 1994 genocide. The Rwandan Government has opened its economy, improved its business climate, and embraced trade and investment as a means to boost economic development and help alleviate poverty. In 2008–2009, Rwanda was the world's most improved country in the World Bank's review of "doing business" reforms—a first for a sub-Saharan African country. The report cited Rwanda's progress in areas such as reducing the time necessary to start a business, making it easier to obtain credit, and providing rules to facilitate trade and the registration of property. Rwanda also maintains a consistent policy of combating corruption.

As the result of these reforms, foreign investors are increasingly giving Rwanda serious consideration as a destination for investment. According to our Embassy, U.S.-led investment in Rwanda is poised to grow from less than \$50 million pre-2008 to more than \$600 million in 3 to 5 years. These investments could increase access to energy significantly for Rwandans and their regional neighbors, expand the number of Rwanda university-educated students from the thousands to the tens of thousands, and provide low-cost "green" housing for middle-income Rwandans. U.S. investment has the potential to change Rwanda's economic landscape and play a significant role in assisting the Rwandan Government's efforts to become an economic hub for Central Africa. The BIT with Rwanda, once in force, would reinforce

<sup>1</sup>The other U.S. BITs with sub-Saharan African countries are with: Cameroon, the Democratic Republic of Congo, Mozambique, the Republic of Congo, and Senegal.

the Rwandan Government's efforts to further reform its economy and promote a strong business climate. It would also set a very positive example in the region.

The Department of State and the Office of the U.S. Trade Representative co-lead the negotiation of this treaty, with the participation of the Departments of Commerce, the Treasury, and other U.S. Government agencies. The treaty, which was signed on February 19, 2008, adheres closely to the text of the 2004 U.S. Model BIT. As such, it contains a set of core investor protections, which include:

- National treatment and most-favored-nation treatment for the full life cycle of investment, including in the establishment, acquisition, operation, management, and ultimate disposition of an investment;
- The free transfer of investment-related funds;
- Prompt, adequate, and effective compensation in the event of an expropriation;
- A minimum standard of treatment grounded in customary international law;
- Freedom of investment from specified performance requirements;
- Prohibitions on nationality-based restrictions for the hiring of senior managers; and
- Provisions on transparency in publication of investment-related laws, regulations, and other measures, and the opportunity, to the extent possible, for interested parties to comment on such proposed measures.

The treaty also provides investors with the opportunity to resolve investment disputes with a host government through international arbitration.

This investment treaty is based on the 2004 U.S. Model BIT, which, compared to earlier BITs, includes a number of provisions designed to improve the operation of the treaty. These developments include greater specificity with respect to key substantive provisions, and rules of procedure designed to eliminate frivolous claims and to enhance efficiency, transparency, and public participation in the arbitration process. The Parties also recognize in the treaty that it would be inappropriate to encourage investment by weakening or reducing the protections afforded in domestic environmental and labor laws. Under the Model, each Party may take limited exceptions to the core obligations related to national treatment, most-favored-nation treatment, performance requirements, and senior management and boards of directors. In this area, Rwanda has taken only a few, narrow exceptions; the treaty thus sends a powerful signal about Rwanda's openness to foreign investment.

In sum, this treaty will complement Rwanda's reform efforts, help Rwanda attract more foreign investment that is vital to economic prosperity, and deepen our economic relationship with an important partner in Africa.

Looking ahead, the administration is interested in exploring possibilities for new U.S. BITs in Africa. On August 5, at an event during the African Growth and Opportunity Act Forum in Nairobi, Secretary of State Clinton and U.S. Trade Representative Kirk announced that the United States would start negotiations toward a BIT with Mauritius. Mauritius is another partner in sub-Saharan Africa that has taken serious steps to enact reforms and improve its business climate. At that time, Secretary Clinton echoed President Obama's call to do more to promote investment in Africa, and commented that the launch of negotiations with Mauritius is in keeping with our broader interest in engaging other potential BIT partners in Africa.

In conclusion, the administration wishes to thank the committee for its consideration of the treaty and we urge you to report it favorably to the full Senate for action.

Senator KAUFMAN. Thank you.

Ms. Jones.

**STATEMENT OF HON. KERRI-ANN JONES, ASSISTANT SECRETARY, BUREAU OF OCEANS AND INTERNATIONAL ENVIRONMENTAL AND SCIENTIFIC AFFAIRS, DEPARTMENT OF STATE**

Dr. JONES. Mr. Chairman, thank you for the opportunity to testify today in support of the International Treaty on Plant Genetic Resources for Food and Agriculture.

The security of U.S. agriculture depends on the stability and high yield of U.S. crops, which in turn is contingent on the continued development of new crop varieties. The crops we grow are always under threats from diseases, pests, drought, and floods. Our

food security will depend in part upon breeding new crops with new traits.

To develop such varieties, breeders and researchers require access to a broad spectrum of genetic raw material which contains traits, such as resistance to virulent pests and disease. Each nation, including the United States, is interdependent on many other nations for access to that genetic material. Consequently, protecting what is termed, "plant genetic resources for food and agriculture" and facilitating international access to such material are critical priorities for the United States and the entire international community.

For the past 40 years, political and legal uncertainty has characterized the environment for international exchanges of agricultural plant genetic resources. During this period, U.S. researchers found it increasingly difficult to gain access to plant breeding materials in other countries. Meanwhile, technological advances significantly improved our ability to identify, characterize, and utilize agricultural genetic resources, thereby increasing the importance of access to gene pools outside of our borders.

By establishing a stable, legal framework for international germplasm exchanges, the treaty benefits both research and commercial interests in the United States. This treaty promotes global food security through the conservation and sustainable use of plant genetic resources for food and agriculture. It creates a multilateral system for access to and benefit-sharing regarding certain plant genetic resources to be used for research, breeding, and training for food and agriculture.

The treaty currently covers the exchange of material for 64 food and feed crops. More may be added in the future through the agreement of the parties.

The treaty entered into force in 2004 and now has a 120 parties. The United States signed the treaty in 2002. The President forwarded it to the Senate for consideration in July 2008. Throughout the negotiating process, the United States was firmly committed to creating a system that promotes U.S. and global food security and protects U.S. access to genetic resources held outside of our borders.

The United States also sought to protect the ability of the international agricultural research centers, the centers that were largely responsible for the Green Revolution, to continue to genetically improve crops that underpin global food security.

The treaty enjoys broad stakeholder support, as you have already mentioned, including several prominent industrial organizations, such as the ones you mentioned, but also the American Soybean Association and the National Association of Wheat Growers.

The treaty is consistent with existing U.S. practice and may be implemented under existing U.S. authorities. No statutory changes are needed.

The Agricultural Research Service, in their role as manager of the National Plant Germplasm System, would play a major role in domestic treaty implementation. For more than 50 years, the U.S. National Plant Germplasm System has distributed samples of germplasm to breeders and researchers worldwide and free of charge, and thereby already contributes significantly to the global

effort to safeguard plant germplasm for food security now and in the future.

Consequently, the United States is already in compliance with key provisions of the treaty, so ratification would not entail major policy or technical changes to the current National Plant Germplasm System as it operates.

Mr. Chairman, the United States Department of Agriculture has long been recognized as the world leader in plant germplasm conservation and distribution. As a party to the treaty, U.S. entities would gain guaranteed access to plant genetic resources covered by the treaty. Ratification of the treaty would underscore our continued leadership, and it would help U.S. farmers and researchers sustain and improve their crops and promote food security for future generations, not only in the United States, but globally.

Thank you, Mr. Chairman, for this opportunity to convey our support for ratification. I would be happy to answer any questions.

[The prepared statement of Ms. Jones follows:]

PREPARED STATEMENT OF ASSISTANT SECRETARY DR. KERRI-ANN JONES, BUREAU OF OCEANS AND INTERNATIONAL ENVIRONMENTAL AND SCIENTIFIC AFFAIRS, DEPARTMENT OF STATE, WASHINGTON, DC

Mr. Chairman and members of the committee, thank you for the opportunity to testify today in support of the International Treaty on Plant Genetic Resources for Food and Agriculture (“the Treaty”).

Mr. Chairman, the security of U.S. agriculture depends on the stability and high yield of U.S. crops which, in turn, is contingent on the continual development of new crop varieties. The crops we grow are always under threats from diseases, pests, droughts and floods. Globalization has acted to bring continuous threats of new pests and diseases into crop-producing areas, which can devastate crops or reduce yields. Our food security will in part depend upon breeding new crops that need less water but still produce high yields. To develop these new crop varieties, breeders and researchers require access to a broad spectrum of “genetic raw material” containing key traits such as immunity to virulent pests and diseases. Each nation—including the United States—is dependent on many other nations for access to that genetic material. Consequently, facilitating international access to what is termed “plant genetic resources for is a critical priority for the United States and the entire international community.

Over time, U.S. researchers have found it increasingly difficult to gain access to plant breeding materials in other countries. Meanwhile, technological advances significantly improved our ability to identify, characterize and utilize agricultural genetic resources, thereby increasing the importance of access to gene pools outside of our borders. By establishing a stable legal framework for international germplasm exchanges, this Treaty benefits both research and commercial interests in the United States. The Treaty also promotes global food security through the conservation and sustainable use of plant genetic resources for food and agriculture.

The centerpiece of the Treaty is the establishment of a “Multilateral System” for access to, and benefit-sharing regarding, certain plant genetic resources to be used for research, breeding, and training for food and agriculture. The scope of the Treaty’s coverage currently encompasses genetic resources of 64 crops and forages that are maintained by International Agricultural Research Centers or that are under the management and control of national governments and in the public domain. Access to covered germplasm is granted through a Standard Material Transfer Agreement, a contract that defines the terms of access and benefit-sharing. Furthermore, the Treaty provides a mechanism for enabling developing countries to acquire the capacities needed to conserve and sustainably use plant germplasm essential for food security, including facing the global challenges associated with climate change.

The Treaty entered into force in 2004 and now has 120 Parties. The United States signed the Treaty in 2002. The President forwarded it to the Senate for consideration in July 2008, after negotiations of the Standard Material Transfer Agreement were completed. Throughout the Treaty negotiating process, the United States was firmly committed to creating a system that promotes U.S. and global food security and protects U.S. access to genetic resources held outside our borders. The United States also sought to protect the ability of the International Agricultural Research

Centers—the institutions largely responsible for the “Green Revolution” which saved billions of lives—to continue to genetically improve crops that underpin global food security. The Treaty enjoys broad stakeholder support, including support for U.S. ratification from several prominent industry organizations such as the American Seed Trade Association, the National Farmers Union, the American Soybean Association, the National Association of Wheat Growers, the National Corn Growers Association, the Biotechnology Industry Organization and the Intellectual Property Owners of America.

Mr. Chairman, the Treaty is consistent with existing U.S. practice and may be implemented under existing U.S. authorities. No statutory changes are needed. The Agricultural Research Service, in its capacity as manager of the National Plant Germplasm System, would play a major role in domestic Treaty implementation. For more than 50 years, the U.S. National Plant Germplasm System has distributed samples of germplasm to plant breeders and researchers worldwide and free of charge, thereby already contributing significantly to the global effort to safeguard plant germplasm for food security, now and in the future. Consequently, the United States is already in compliance with key provisions of the Treaty, and ratification would not entail major policy or technical changes to current National Plant Germplasm System operations.

Mr. Chairman, the United States Department of Agriculture has long been recognized as the world leader in plant germplasm conservation and distribution. If the U.S. ratified the Treaty, U.S. entities would gain guaranteed access to plant genetic resources covered by the Treaty. As I have highlighted before, global access to plant genetic resources is critical to the efforts of researchers and plant breeders to develop new crop varieties that are more nutritious, are resistant to pests and diseases, show improved yields, and are better able to tolerate environmental stresses. The emergence of new biotechnology-based plant breeding tools only heightens the importance of open access to plant genetic resources.

Ratification of the Treaty would not only underscore our continued leadership but it would also help U.S. farmers and researchers sustain and improve their crops and promote food security for future generations, not only in the United States but globally.

Senator KAUFMAN. Thank you very much.

Ms. Corwin, as has been pointed out, our existing treaties with Belgium, Germany, and Canada have mandatory arbitration requirements. How does Treasury decide whether treaties should include mandatory arbitration?

Ms. CORWIN. Thank you, Mr. Kaufman.

We look at arbitration as an appropriate extension of our current competent authority process to resolve disputes, and we think it is appropriate to resolve disputes in almost every treaty. At the moment, we consider arbitration on a case-by-case basis, looking to what the other treaty country thinks about the provision, but also the history of disputes and the difficulty of disputes we have with a particular jurisdiction—you know, the historic aspects of it.

Senator KAUFMAN. Are you thinking about making it standard for all treaties?

Ms. CORWIN. It is something, again, we think is appropriate as a dispute resolution mechanism. At the moment we are not making it—going to make it part of our model, but we are going to continue to study it as an effective tool and consider that for the future.

Senator KAUFMAN. How do you feel about the idea of reporting on these arbitration?

Ms. CORWIN. I’m sorry?

Senator KAUFMAN. How do you feel about reporting more on the arbitration process in these treaties?

Ms. CORWIN. We are comfortable continuing to report on the process and continue to work with this committee on refining the effectiveness of it as a tool.

Senator KAUFMAN. And you feel pretty good about the Malta treaty, that we've overcome the problems we've had in the past and are ready to terminate the former treaty?

Ms. CORWIN. Yes, we are comfortable. Since the treaty was terminated, a number of significant changes have been made in Malta. They, mostly importantly, as of 2008, repealed their bank secrecy rules that were an impediment to information exchange. Since 1996, they've also acceded to the EU, which has caused them to implement a number of EU directives—like the money laundering directive, the savings directive—that have assured their participation in mutual assistance programs, and also ensured that they would have to commit to international transparency standards.

With regard to the treaty-shopping concerns, there are a number of factors that make a jurisdiction an attractive target for treaty-shoppers. As my colleague has mentioned, the internal domestic laws of that jurisdiction are one of those factors, but other factors include the attractiveness of the treaty itself that's in existence in terms of the source-country withholding rates, as well as the limitation on benefits. In this treaty, we have not—unlike a lot of our treaties, where we have gone to zero on withholding source-country withholding with respect to dividends, interest, and royalties, we have, in this treaty, included positive rates of withholding, which makes it a less attractive target for treaty-shoppers. But most importantly, we have included a very robust “limitation on benefits” provision that makes it very difficult for a third country to use Malta to strip income out of the United States with a—and notably, a provision that prevents payments out of a Maltese corporation to a third country that would, we feel, “alleviate” our treaty-shopping concerns.

Senator KAUFMAN. Great.

Mr. Barthold, can you kind of summarize—you have a number of concerns about the mandatory arbitration—can you talk a little bit about that?

Mr. BARTHOLD. Well, our concerns were more just questions of direction and consistency. The one that I noted was, in two cases now, we have that arbitration will be available with respect to any aspect of the treaty. In two of the other existing treaties, it's a narrower scope. So, our question was really, “Why the broader scope in some cases, the narrower scope in others?” Going forward, if it is the intent, as might have been suggested, to use this as an additional tool to resolve disputes, how broadly should it be applied, or should it be applied in more narrow circumstances?

We also had some questions about the precise role of the taxpayer position paper. I guess I would say that it's somewhat unclear to us what benefit that necessarily brings to the process, since the two parties would be, hopefully, fully—the two countries—would hopefully be fully explaining the position that they took. I guess it is conceivable the taxpayer could provide some additional information, but one would think that the taxpayer might have been working in concert with one of the two contracting states to begin with.

Then there's also the issue related to the arbitration proceedings and the results as to what sort of precedents they might provide

for future cases of dispute. Across the four possible arbitration countries, that's left somewhat unclear, in that, while each of the treaties said there's no precedential value—at least in the case of the German Treaty, it's—while there's no precedential value, if you get a similar dispute, it's hoped that you get a similar outcome. And that's stated as part of the explanation of how arbitration would work.

So, I think our questions or our concerns are just a little bit more of the unknown. How does Treasury think this will be refined, going into the future.

Senator KAUFMAN. And do you think there should be some kind of a standard arbitration provision?

Mr. BARTHOLD. Well, if we think that this is an important thing to do, an important part of providing for dispute resolution, I think it would be important to outline that as part of the model treaty.

Now, of course, in practice, when the Treasury negotiates with other countries, you never get a result that looks exactly like the model, because the other country has opposing goals. I mean, the model lays out what we think is a good, reasonable approach, and a lot of times we end up there, but I wouldn't expect that we'd have uniformity across all provisions. But, the model, in stating what we think would be a good, reasoned approach, does also help guide us when we go forward in negotiations. So, I think there would be some benefit to thinking through what would be a good, reasoned approach.

Senator KAUFMAN. And you asked—you think we should ask questions about additional reporting requirements. What would be the objective of additional reporting requirements, in your mind?

Mr. BARTHOLD. The reporting requirements? I was just pointing out that, technically, the requirement of the Senate from last year only applies to the treaties with Belgium, Canada, and Germany. So, you'd have to broaden that requirement to bring in France.

Now, in practice, there really can't be any reporting until there's arbitration. And I believe it's 10 cases. Right? And, it's largely the hope, I believe, of the countries that have negotiated arbitration as part of the treaties, that they may never get to arbitration; that, in fact, arbitration itself will be seen as either an embarrassment to the competent authorities or an additional spur that helps the competent authorities reach a resolution. And then, we don't actually get to arbitration, in most cases, until after a 2-year clock has started.

So, I don't imagine we're anywhere near to getting anybody into arbitration quite yet, and it'll take a while to build up 10 cases. But, if we were to include reporting on possible French arbitration cases, given the differences in scope across the different treaties, given the fact that France will permit taxpayer participation, a report would be very interesting, just to see how the incomes matter, how the report of the taxpayer matters, how the breadth or narrowness of the scope matters. So, we think it would be a worthwhile thing for the committee to request in regard to the mandatory arbitration in the French protocol.

Senator KAUFMAN. Thanks.

Mr. Scholz, do you expect investment in Rwanda to increase significantly once we enter into this treaty?



Mr. SCHOLZ. As I mentioned in my testimony, our investment in Rwanda in 2008 amounted to about \$50 million, and the Embassy has projected that that could go up as much as—up to \$600 million in the next few years.

There is interest on the part of United States investors in the areas of green housing, education, infrastructure—particularly energy infrastructure—in Rwanda. So, those are important areas where we could see some actual growth in U.S. investment flows.

Senator KAUFMAN. Again, what businesses do you think would be going in there—what United States businesses will be investing in Rwanda, do you think, after the treaty?

Mr. SCHOLZ. Well, again, it would—it—there are firms in those sectors that we've been told have been interested. I can't give you specific companies at this point, but I'd be happy to followup with more specifics.

Senator KAUFMAN. That'd be great.

[The information provided by Mr. Scholz follows:]

I can provide a few examples of U.S. companies that have made or are making significant investments in Rwanda. In March of this year, U.S. firm ContourGlobal announced that it reached agreement with the Government of Rwanda to invest \$325 million in methane gas extraction and power generation. U.S. firm Eco-Fuel and a British partner recently announced they will undertake a \$300 million renewable energy project using jatropha to produce biofuel in Rwanda. Sorwathe, a U.S. tea company that has invested Rwanda since 1978, recently opened a new \$2 million tea factory in the country. Also this year, Starbucks Coffee opened a "Farmer Support Center" in Kigali, the first such investment by the company in Africa. We understand from our Embassy in Kigali that a number of other U.S. firms are giving Rwanda a serious look as a potential investment destination.

Of course, the existence of a BIT is one of many factors that investors may consider in making their investment decisions, but bringing the BIT into force would further improve the attractiveness of Rwanda's investment climate.

Senator KAUFMAN. Thank you very much.

How does a treaty fit into our bilateral relations with Rwanda on human rights?

Mr. SCHOLZ. We've—Rwanda's made admirable advances over the last decade in economic development and making significant progress in adjudicating an enormous backlog of genocide cases. Despite these advances, Rwanda continues to face significant challenges regarding reconciliation, human rights, democratization, as it continues its efforts to rebuild a society torn asunder by war and genocide. The United States and the international community continue to work toward the goal of a stable, growing, democratic Rwanda with improved respect for human rights. Specifically, the United States works with the Government of Rwanda to open the political space, increase civil liberties, and to strengthen the judiciary.

The treaty itself can promote economic development and employment in Rwanda, as well as improve the rule of law and transparency. These objectives are complementary to our efforts to work with the Rwandan Government to improve human rights and democracy in Rwanda.

We also continue to use other channels to raise our views on issues of human rights and democratization. These include our bilateral dialogues and other contacts and the Annual AGOA Country Review and the Department's Annual Human Rights Report.

Senator KAUFMAN. Good. This is important, that we keep talking to them about these human rights. I mean, they've—civil society abuse, torture, you know, a number of things going on there. Yes, they've come a long way, but they still have a way to go.

Mr. SCHOLZ. Yes—

Senator KAUFMAN. Thank you.

Mr. SCHOLZ [continuing]. Well it's an important objective for the Department.

Senator KAUFMAN. It is.

Ms. Jones, Plant Genetic Resources Treaty. Can you give us some examples of a problem this treaty will help solve?

Dr. JONES. Yes, thank you, Mr. Chairman.

I think that the kind of problems that need to be solved, from the sense of what's happening around the world regarding crops being under stress, is the sort of thing that we're seeing with wheat rust. This is a disease that has emerged—reemerged recently, a virulent strain that is likely to affect the U.S. wheat crops. Eighty percent of them are—look like they are vulnerable to it.

It's the sort of thing where we would need to go outside of our own genetic resource base to see if we can help ourselves, as well as the world, to find resistance to this kind of disease. And with this particular example, we're working with two of the international agricultural research centers—the one that deals with wheat and the one that deals with dryland agriculture—looking at their genetic resources.

And so, having access to these resources is hugely important, because we need to be able to look broadly for traits that solve problems, as well as bring forward new strains and varieties that could be more resistant and more productive.

Senator KAUFMAN. Can you tell me a little bit about how this will help global food security?

Dr. JONES. Certainly.

It helps global food security in that it stimulates research and it allows important food crops to be researched in a way that will help them be more productive, and also be able to grow in areas that are more marginal and more stressed. And that's likely—and we see it now, that's what's happening in agriculture around the world. Lands are being affected by a number of things, including climate change. And so, we will need crops that have different kinds of resiliencies. And to find that, we will have to look to genetic databases, genetic resources around the world.

And so, it's an underpinning to food security, in that it's a resource that will let us get to the crops that we will eventually need worldwide.

Senator KAUFMAN. Good.

I want to thank the witnesses for their testimony and for their questions.

Because tomorrow's a holiday, I'll leave the record open until noon on Thursday.

That said, I understand the chairman will take up the French—France protocol at a business meeting on November the 17th, so it'll be best to submit any questions on the record for the treaty by close of business today, if possible.

Thank you very much.  
 [Whereupon, at 9:40 a.m., the hearing was adjourned.]

#### ADDITIONAL QUESTIONS AND ANSWERS SUBMITTED FOR THE RECORD

##### RESPONSES OF MANAL CORWIN TO QUESTIONS SUBMITTED BY SENATOR JOHN F. KERRY

*Question.* Michael McIntyre, professor of law at Wayne State University and Robert S. McIntyre, Director of Citizens for Tax Justice, have criticized the information exchange provisions in the France and New Zealand protocols and the Malta treaty as inadequate and obsolete. They are concerned the provisions would only provide for an exchange of information on specific request. They assert that the emerging international standard for effective exchange of information requires information not only on specific request but also automatic and spontaneous exchanges. Why do the information exchange provisions for these treaties not include automatic and spontaneous exchanges?

*Answer.* The provisions for exchange of information in the proposed tax treaty with Malta and the proposed protocols with France and New Zealand comply with the U.S. and international standards for full exchange of information under income tax treaties. The treaty provisions permit information exchange on request, on a routine (or automatic) basis, and on a spontaneous basis. This level of information exchange is consistent with international standards. The United States is committed to robust information exchange for tax purposes and has been a leader in efforts to improve information exchange worldwide. We continue to work with colleagues in other jurisdictions to improve mechanisms for information exchange, including with respect to "routine" or "automatic" exchange.

*Question.* The United States has automatic exchanges of information under its tax treaties with Canada and Mexico. France is supporting automatic exchanges of information with its EU partners. Why should the treaty with France be different than the treaties with Canada and Mexico?

*Answer.* As is the case with the U.S. Model tax treaty and all modern U.S. tax treaties, the tax treaties with Canada and Mexico permit, but do not require, the revenue authorities to exchange information on an automatic basis. The provisions for exchange of information in the proposed protocol with France similarly permit, but do not require, the revenue authorities to exchange information on an automatic basis. In this regard the treaty with France is fully consistent with U.S. and international standards as they have existed for a number of years. The Treasury Department is working with other treaty countries to encourage and improve the mechanisms for effective exchange of information, including mechanisms for routine or automatic information exchange.

*Question.* Problems related to bank secrecy have been highlighted recently by the UBS case. Do you think the Malta treaty and the France and New Zealand protocols would improve the exchange of information in a manner sufficient to prevent another UBS from happening?

*Answer.* The information exchange articles in the Malta treaty and the France and New Zealand protocols conform with U.S. and international standards for information exchange and thus override any domestic bank secrecy provisions. However, even in countries with which the United States has an effective comprehensive exchange of information program that conforms to international standards, uncooperative foreign banks can in some circumstances conceal overseas investments by U.S. persons. Thus, in addition to focusing on information exchange in bilateral negotiations, the Treasury Department is pursuing a multipronged approach that includes legislative proposals, multilateral initiatives to improve transparency and information exchange in tax matters, and IRS enforcement actions. This multipronged approach is intended to provide the IRS with the information (from taxpayers, third parties, and other countries) and the tools needed to tackle offshore tax evasion.

*Question.* One of the reasons the tax treaty was terminated with Malta was concerns about the exchange of information. Why do you believe now that there will be an adequate exchange of information?

*Answer.* Concerns about inadequate information exchange were among the factors that led the United States to terminate the prior tax treaty with Malta. The negotiations focused heavily on addressing this concern. Since 1997, Malta has made key

changes to its domestic law regarding exchange of tax information. Most importantly, in 2008 Malta changed its law to permit the exchange of information held by financial institutions. This change made it possible for Malta to agree to comprehensive information exchange obligations in the proposed treaty that meet U.S. and international standards. As a member of the European Union, Malta is also required to conform to international transparency norms. Because of these recent developments in Malta, the Treasury Department believes that Malta will be able to comply with its information exchange obligations under the proposed treaty.

*Question.* Is the limitations on benefits article included in the Malta treaty sufficient to prevent the use of the treaty by persons that are not residents of the United States or Malta?

*Answer.* Yes. The features of Malta's tax system were taken into account in negotiating the limitation on benefits provision of the proposed treaty. As a result, the limitation on benefits article in the proposed treaty with Malta is significantly more restrictive than the limitation on benefits provisions in the 2006 U.S. Model tax treaty or in any existing U.S. tax treaty. The Treasury Department believes that this limitation on benefits article is sufficient to prevent abuse of the treaty by third-country investors. In addition, the proposed treaty also provides relatively high rates for source-country taxation of dividends, royalties, and interest which make Malta unattractive as a treaty shopping jurisdiction.

RESPONSES OF MANAL CORWIN TO QUESTIONS SUBMITTED BY SENATOR RICHARD G. LUGAR RELATING TO THE TAX CONVENTION WITH MALTA

TREATY SHOPPING

*Question.* November 16, 1995, the United States delivered a notice of termination to Malta stating that the income tax treaty between the two countries would cease to have effect as of January 1, 1997. The termination of the treaty was due, at least in significant part, to Treasury's concern with changes in prior Maltese law that might have inappropriately facilitated the use of the treaty by persons who were not residents of Malta or the United States.

- In light of the prior treaty history, what considerations were taken by Treasury to determine that it was appropriate to enter into a new income tax treaty with Malta?

*Answer.* The United States terminated the prior tax treaty with Malta because of concerns about the potential for treaty shopping and because of Malta's inability to adequately exchange information with the United States. Since 1997, significant changes in Malta's domestic law relating to exchange of information have been enacted and Malta has agreed to provisions in the proposed treaty that protect against treaty shopping concerns. Most importantly, in 2008 Malta changed its law to permit the exchange of information held by financial institutions. This change made it possible for Malta to agree to include comprehensive information exchange obligations in the proposed treaty that meet U.S. and international standards. In addition, Malta acceded to the European Union in 2004. As a member of the European Union, Malta is required to conform to international transparency norms. Finally, Malta agreed to antitreaty shopping rules in the proposed treaty designed to ensure that treaty benefits would be restricted to bona fide residents of the United States and Malta. The limitation on benefits article in the proposed treaty is more restrictive than the limitation on benefits article found in the 2006 U.S. Model tax treaty or in any existing U.S. tax treaty. Moreover, the proposed treaty also provides relatively high rates for source country taxation of dividends, royalties, and interest. Taken together, these recent developments in Malta's domestic law and the strong protections in the proposed limitation on benefits article have lead Treasury to conclude that it is appropriate to enter into the proposed treaty with Malta.

*Question.* Do the provisions of the proposed treaty, taken together, alleviate all concerns that led the Treasury Department to terminate the prior treaty?

*Answer.* Yes. The provisions of the proposed tax treaty differ from the terms of the prior tax treaty with Malta in two key aspects. First, the proposed tax treaty provides for a full exchange of information that meets U.S. and international standards. This includes the obligation to obtain and provide information held by banks. Second, the proposed tax treaty contains a comprehensive limitation on benefits provision that would restrict treaty benefits to residents of the United States and Malta. The proposed treaty also provides relatively high rates for source country taxation of dividends, royalties, and interest.

*Question.* According to the Joint Committee on Taxation Explanation on this proposed treaty, Maltese law still includes a number of characteristics that are conducive to some of the concerns that led to the termination of the previous treaty with Malta. For example, payment of dividends and interest to foreign persons are not subject to withholding tax in Malta. In addition, tax treatments of foreign subsidiaries in Malta might contribute to tax treaty benefits being extended to non-United States and Malta residents.

- Considering these concerns, is the limitation-on-benefits article sufficient to prevent the use of the proposed treaty by persons that are not residents of the United States or Malta?

*Answer.* Yes. There are several factors that make a jurisdiction an attractive location for treaty shopping. A favorable domestic tax regime is only one of those factors. Other essential factors, however, include favorable treaty rates on source country taxation and an ability to access those rates by qualifying for treaty benefits. The rates for source-country taxation of dividends, interest, and royalties in the proposed treaty with Malta are higher than most U.S. income tax treaties. In addition, the limitation on benefits provision in the proposed treaty is significantly more restrictive than the limitation on benefits provisions in the 2006 U.S. Model tax treaty, or in any existing U.S. tax treaty making it very difficult for a non-resident investing in the United States through Malta to qualify for the benefits of the treaty. This limitation on benefits article is sufficient to prevent abuse of the treaty by persons that are not residents of the United States or Malta.

*Question.* Since the limitation-on-benefits article is a deviation from the U.S. Model tax treaty, will legitimate persons be able to qualify for benefits under the proposed treaty?

*Answer.* Yes. The objective tests in the proposed limitation on benefits article are designed to allow residents of the United States and Malta to enjoy the benefits of the tax treaty. In addition, as is the case with all U.S. tax treaties containing modern limitation on benefits provisions, legitimate investors who nevertheless fail to satisfy any of the objective criteria may be granted treaty benefits at the discretion of the revenue authorities of the relevant jurisdiction.

#### WITHHOLDING RATES

*Question.* Under the proposed treaty, the withholding rates are a deviation from the U.S. Model tax treaty and may discourage non-United States and Malta residents from receiving benefits. When does the Treasury Department believe that is appropriate to deviate from the withholding tax rates provided in the U.S. Model treaty?

*Answer.* The withholding rate reductions in income tax treaties are negotiated on a case-by-case basis, taking into account several factors, including the bilateral economic relationship with the proposed treaty partner, the cross-border flows of income between the two countries and the particular features of the tax system of the proposed treaty partner. As a result, the withholding rate limitations agreed to in a particular treaty will sometimes differ from the withholding rate reductions provided in the U.S. Model tax treaty.

#### TRIANGULAR ARRANGEMENTS

*Question.* The proposed treaty includes special antiabuse rules intended to deny treaty benefits in certain circumstances in which a Malta-resident company earns U.S.-source income attributable to a third-country permanent establishment and is subject to little or no tax in the third jurisdiction and Malta.

- What criteria will the Treasury Department consider in determining when antiabuse rules applicable to triangular arrangements will be included in future treaty negotiations?

*Answer.* Under prior policy, the Treasury Department sought to include a limitation on benefits provision to address so-called “triangular arrangements” only when the treaty partner used an exemption system to eliminate double taxation. However, in recent years the Treasury Department has chosen to seek the inclusion of such a rule in all new income tax treaties. A rule addressing triangular arrangements will likely be included in the next revision of the U.S. Model tax treaty.

RESPONSE OF MANAL CORWIN TO QUESTION SUBMITTED BY SENATOR RICHARD G. LUGAR RELATING TO THE PROTOCOL AMENDING THE TAX CONVENTION WITH NEW ZEALAND

*Question.* Why does the tax protocol with New Zealand not include an arbitration provision such as has been included in recent tax treaties with Canada, Germany, and Belgium along with the recently negotiated protocol to the tax treaty with France?

*Answer.* The Treasury Department believes that mandatory binding arbitration can be an effective tool to facilitate the resolution of disputes between the revenue authorities of the two countries party to a tax treaty. The Treasury intends to raise the inclusion of an arbitration provision with our treaty partners on a case-by-case basis. While we discussed with New Zealand the possibility of including an arbitration provision, we ultimately decided not to do so, because we have not had any difficulties or disputes with the New Zealand tax authorities in the application of the existing tax treaty.

RESPONSES OF MANAL CORWIN TO QUESTIONS SUBMITTED BY SENATOR RICHARD G. LUGAR REGARDING THE PROTOCOL AMENDING THE UNITED STATES-FRANCE TAX TREATY

ARBITRATION

*Question.* The France Protocol is the fourth tax treaty Treasury has concluded that contains binding arbitration procedures for resolving disputes between the competent authorities regarding the application of the Convention. What criteria will the Treasury Department use to determine whether a future treaty should include mandatory binding arbitration?

*Answer.* The Treasury Department believes that mandatory binding arbitration, as an extension of the competent authority negotiation process, is an effective tool to strengthen the Mutual Agreement Procedure and to achieve prompt and efficient settlement of disputes between two tax authorities. The Treasury Department has been discussing mandatory binding arbitration in general terms with our treaty partners, and intends to continue to raise inclusion of a mandatory binding arbitration provision with our treaty partners in future negotiations. In considering a mandatory binding arbitration provision with our treaty partners, the volume of cases, the nature of the relationship between the two competent authorities, and the treaty partner's views with respect to such a provision are important factors. Mandatory binding arbitration remains a relatively new mechanism for resolving disputes under our tax treaties, and going forward we will study the effectiveness of the arbitration provisions we have concluded so far. The Treasury Department welcomes input from the committee concerning the factors that should be taken into account when considering whether to include an arbitration provision in the context of the negotiation of a particular agreement.

*Question.* The arbitration provision in the France Protocol permits the arbitration of any case under any article of the treaty, unless the competent authorities agree that the case is not suitable for arbitration. Under the Canada and Germany treaties, similar arbitration procedures apply only to disputes arising under specified articles of the treaty. What factors did Treasury consider in deciding to adopt a broader scope for arbitration of disputes under the France Protocol than under the Canada and Germany treaties?

*Answer.* The Treasury Department believes that mandatory binding arbitration can be beneficial in resolving all disputes that might arise under an income tax convention. France agreed with the United States in this regard. However, the scope of an arbitration provision in a particular agreement is a matter that must be negotiated with the treaty partner. As a first step, some countries may only be willing to cover specific articles of a treaty. We believe it is important to make that first step with appropriate treaty partners. Also, it should be noted that while the mandatory binding arbitration provision in the agreements with Canada and Germany are limited to certain articles, other issues are eligible for arbitration if the competent authorities agree that the particular case is suitable for arbitration.

*Question.* Describe Treasury's experience to date with the arbitration provisions in the tax treaties with Belgium, Canada, and Germany? Has the possibility of arbitration facilitated negotiated resolution of disputes under these treaties? Does Treasury envision significant numbers of cases being submitted to arbitration under these treaties in the next 2 years?

Answer. With respect to the arbitration provision in the agreement with Germany, on December 8, 2008, the U.S. and German competent authorities entered into a memorandum of understanding and agreed on arbitration guidelines concerning a number of procedural matters to ensure the effective implementation of the arbitration provision. Similarly, with respect to the Belgian arbitration provision, on May 6, 2009, the U.S. and Belgian competent authorities entered into a memorandum of understanding and agreed on arbitration guidelines. In compliance with the arbitration reporting requirements described in the report of the Senate Foreign Relations Committee on the 2007 United States-Canada protocol, the Treasury Department transmitted these documents to the Committees on Finance and Foreign Relations of the Senate and the Joint Committee on Taxation on November 9, 2009.

With respect to the arbitration provision in the agreement with Canada, the U.S. competent authority began discussions with Canada earlier this year to provide guidance on procedural aspects of the arbitration provision.

The agreements with Belgium, Canada, and Germany have only been in force for a short period of time. (The Germany and Belgium agreements entered into force in December 2007, and the agreement with Canada entered into force in December 2008.) No cases have yet been submitted to arbitration under the agreements with Germany, Belgium, or Canada. However, we believe that the prospect of impending mandatory binding arbitration creates an incentive for the competent authorities to reach agreement on a case before the arbitration process commences. Consequently, we expect MAP negotiations to continue to resolve the great majority of cases and do not anticipate a significant number of cases to require resolution through arbitration. The Treasury Department will monitor the performance of the provisions in the agreements with Belgium, Canada, and Germany, as well as the performance of the provision with France, if ratified.

*Question.* Describe the opportunities for taxpayer participation under the arbitration provisions of the French Tax Protocol. What issues will taxpayers have the opportunity to address in submissions to the arbitration panel? Will taxpayers have the opportunity to address the proposed resolutions submitted by the competent authorities?

Answer. The Treasury Department contemplates that if the proposed protocol with France is approved, the U.S. competent authority will work closely with the French competent authority to provide procedural guidance on the application of the United States-French arbitration provision, just as the U.S. competent authority has recently done with the German and Belgian competent authorities and is doing with the Canadian competent authority. The Treasury Department expects that such guidance will include guidance on the provision permitting affected persons to submit a position paper to the arbitration panel. Under the Memorandum of Understanding with France, the taxpayer is permitted to submit a position paper within 90 days of the appointment of the chair of the arbitration panel. The Memorandum of Understanding does not limit the issues that the taxpayer may address in its position paper, nor does it prevent the taxpayer from addressing the proposed resolutions submitted by the competent authorities. If the proposed protocol is approved, the Treasury Department will monitor the operation of the arbitration provision, including the rule allowing affected persons to submit a position paper. The Treasury Department is committed, in future discussions with our treaty partners concerning the inclusion of an arbitration provision, to striking the appropriate balance between allowing taxpayer input while maintaining the efficiency and effectiveness of the competent authority process, and the Treasury Department welcomes further input on this provision from the committee.

#### AUTOMATIC INFORMATION EXCHANGE AND JOHN DOE SUMMONSES

*Question.* Given language barriers and translation difficulties, potentially vast amounts of information, and different tax reporting periods, are there any practical impediments to automatic information exchange with France?

Answer. The question identifies some of the impediments the IRS faces in any automatic exchange process. A major practical impediment to utilization of information received through automatic exchange is the lack of a U.S. tax identification number (TIN) associated with the information received.

*Question.* If the protocol to the French Tax Treaty goes into force, what mechanisms are in place to facilitate the removal of any impediments that have been identified in the previous question?

Answer. The IRS and Treasury are addressing the practical impediments for effective automatic exchange of information, including the lack of a TIN, by working

with specific treaty partners, including France, and also through OECD committees whose goal is to adopt tax identification numbers as a tool and collect foreign tax identification numbers when possible so that such identification numbers can be included in automatic exchange.

*Question.* Does the Treasury Department expect any practical impediments from existing Federal or State law or rules in fulfilling obligations under the French Tax Protocol?

*Answer.* The United States fully complies with its exchange-of-information obligations under its tax treaties.

*Question.* Under the French Tax Protocol, will France be required to exchange information in response to specific requests that are comparable to John Doe summonses under U.S. domestic law?

*Answer.* The protocol authorizes the competent authorities to exchange information as may be relevant for carrying out the provisions of the Convention or to the administration or enforcement of the domestic laws concerning taxes imposed by the Contracting States, insofar as the taxation under those domestic laws is not contrary to the Convention. A specific request under the French tax treaty must generally identify the taxpayer (or taxpayers) whose income tax liability is in question and explain how the requested information may be relevant for carrying out the provisions of the treaty or the tax laws of the requesting state. A request may be possible in the case of an unnamed taxpayer or taxpayers if the taxpayer or group can be identified through other means, such as by a specified account number that the taxpayer is known to have used or some other identifying characteristics.

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RESPONSES OF WESLEY SCHOLZ TO QUESTIONS SUBMITTED BY SENATOR RICHARD G. LUGAR REGARDING THE UNITED STATES-RWANDA BILATERAL INVESTMENT TREATY

*Question.* In its 2008 decision in *Medellin v. Texas*, 128 S.Ct. 1346 (2008), the Supreme Court concluded that the United States lacked the authority in U.S. law to give effect to a judgment of the International Court of Justice relating to U.S. obligations under the Vienna Convention on Consular Relations. The Foreign Relations Committee has previously stressed its view that it is important that the United States comply with its treaty obligations, and has observed that the committee generally does not recommend that the Senate give advice and consent to treaties unless it is satisfied that the United States has sufficient domestic legal authority to implement them. With these considerations in mind, please indicate what authorities Federal and State governments will rely on to implement the various obligations the United States would assume upon becoming party to this treaty.

*Answer.* The United States is able to implement the proposed United States-Rwanda Bilateral Investment Treaty (BIT) sufficiently under existing legal authority and thus no further legal authority is necessary to implement the treaty. The Convention on the Recognition and Enforcement of Foreign Arbitral Awards, as codified in the Federal Arbitration Act, 9 U.S.C. § 201, and the Convention on the Settlement of Investment Disputes Between States and Nationals of Other States, as implemented domestically, 22 U.S.C. § 1650a, would apply, as relevant, in the context of enforcement of investor-State arbitration awards rendered pursuant to the proposed BIT.

*Question.* Article 37 of the treaty provides for certain disputes between the parties to the treaty concerning its interpretation or application to be submitted to binding arbitration. What authorities would the administration intend to rely upon to implement any state-to-state arbitral decisions awarded against the United States pursuant to this article?

*Answer.* State-to-State arbitrations are extremely rare. In fact, no State-to-State arbitrations have taken place to date under U.S. bilateral investment treaties. Nevertheless, there are various tools at our disposal for implementing a State-to-State award should the situation arise.

Articles 3 through 10 of the BIT and other provisions that qualify or create exceptions to these Articles, such as Article 15, are self-executing but do not confer a private right of action. All remaining articles of the BIT are non-self-executing. As a result, should an arbitral decision conclude that U.S. State law is inconsistent with the BIT, the U.S. Government could, if necessary, choose to initiate a legal action against the State to ensure compliance with a self-executing provision of the BIT. To the extent an arbitral decision determines that Federal law is inconsistent with the BIT and an award addresses a self-executing provision of the BIT, then as long



as the statute in question predated the entry into force of the treaty, the later-in-time self-executing BIT provision would prevail over the earlier inconsistent statute.

To the extent an award addresses Article 11 of the BIT, which is a non-self-executing provision of the BIT establishing investment protections and subject to State-to-State arbitration, the U.S. Government could seek legislation where no other existing authority permitted it to comply with the award or take other appropriate steps, such as seeking to interpret the statute in a manner that is consistent with the arbitral decision. Under current U.S. law, however, existing Federal authorities, for example, the Administrative Procedures Act, 5 U.S.C. § 551 et. seq., along with comparable state-level authorities, adequately ensure compliance with the transparency standards established in Article 11 of the BIT.

Finally, were a State-to-State tribunal to award money damages against the United States, funds to satisfy such an award could be sought from appropriated funds, if any, or from the Judgment Fund (31 U.S.C. § 1304) to the extent appropriate.

In brief, should a dispute between the Parties lead to arbitration pursuant to the mechanism provided for in Article 37, there are a number of options available for implementing State-to-State arbitral decisions.

*Question.* What is the value of existing investments in the United States by Rwandan investors? What are the most significant sectors in which such investments occur?

*Answer.* According to the Department of Commerce's Bureau of Economic Analysis, there is no direct investment in the United States from Rwanda as a foreign parent.

*Question.* By how much does the administration expect Rwandan investment in the United States to increase if the treaty enters into force?

*Answer.* It is difficult to say with precision what impact a U.S. bilateral investment treaty (BIT) may have on investment flows given the wide range of factors that investors consider when making investment decisions. There is presently no foreign direct investment in the United States from Rwanda as a foreign parent, according to the Department of Commerce's Bureau of Economic Analysis. According to UNCTAD, Rwanda's outward foreign direct investment flows worldwide were \$14 million in 2008.

*Question.* What is the value of existing investments in Rwanda by U.S. investors? What are the most significant sectors in which such investments occur?

*Answer.* According to the Department of Commerce's Bureau of Economic Analysis, U.S. direct investment in Rwanda on a historical cost basis was \$1 million in 2008, concentrated in the wholesale trade sector. A number of new U.S. investments in Rwanda were undertaken or announced in 2009. For example, in March 2009, U.S. firm ContourGlobal announced that it reached agreement with the government of Rwanda to invest \$325 million in methane gas extraction and power generation. U.S. firm Eco-Fuel and a British partner recently announced they will undertake a \$300 million renewable energy project growing jatropha to produce biofuel in Rwanda. Sorwathe, a U.S. tea company that has invested in Rwanda since 1978, recently opened a new \$2 million tea factory in the country. Also this year, Starbucks Coffee opened a "Farmer Support Center" in Kigali, the first such investment by the company in Africa. We understand from our Embassy in Kigali that a number of other U.S. firms are considering Rwanda as a potential investment destination.

*Question.* By how much does the administration expect U.S. investment in Rwanda to increase if the treaty enters into force?

*Answer.* U.S. bilateral investment treaties (BITs) play an important role by establishing rules that protect the rights of U.S. investors and providing market access for future U.S. investment. They also promote transparency and the rule of law. In doing so, we believe the BIT will assist Rwanda's efforts to improve its investment climate and attract more foreign investment. It is difficult to say with precision what effect a U.S. BIT may have on investment levels given the wide range of factors that investors consider when making investment decisions.

*Question.* As you mentioned in your recent testimony before the committee, Bilateral Investment Treaties have been negotiated "with the objective of protecting U.S. investment abroad, encouraging the adoption of open, transparent, and nondiscriminatory investment policies, and supporting the development of international legal standards consistent with these objectives." How will the Department of State ensure that these and other objectives continue to be met and developed in Rwanda?

Answer. Once in force, the treaty will provide a strong framework of protections that support the objectives identified in my testimony. In the event of an investment dispute, the treaty provides an investor-State arbitration procedure that allows investors to bring claims against the host government for alleged breaches of the treaty. The treaty also contains a State-State dispute settlement mechanism.

The Department and other executive branch agencies will also continue to use other channels to promote these objectives. These efforts include our bilateral contacts with the Rwandan Government generally, the United States-Rwanda Trade and Investment Council, led by the Office of the U.S. Trade Representative, and the Overseas Private Investment Corporation's programs in Rwanda (which are authorized under a separate bilateral Investment Incentive Agreement between the two governments).

*Question.* If this proposed treaty comes into force, what affect does the Department of State estimate it will have on the region and Rwanda's neighbors?

Answer. As the treaty embodies high standards of investor protection, market access, and transparency, we believe it will set a very positive example in the region. This is particularly the case as countries in the region compete with one another to attract foreign direct investment that supports economic growth and jobs.

*Question.* Besides the recently announced negotiations with Mauritius, is the administration considering announcing the commencement of other BIT negotiations before the review of the current U.S. model BIT treaty is concluded?

Answer. Although we continue to work to identify candidates for U.S. bilateral investment treaty (BIT) negotiations, we have no current plans to announce any new BIT negotiations. The administration is working to finalize the review of the model BIT as expeditiously as possible.

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RESPONSES OF ASSISTANT SECRETARY KERRI-ANN JONES TO QUESTIONS SUBMITTED BY SENATOR RICHARD G. LUGAR REGARDING THE TREATY ON PLANT GENETIC RESOURCES FOR FOOD AND AGRICULTURE

*Question.* In its 2008 decision in *Medellin v. Texas*, 128 S.Ct. 1346 (2008), the Supreme Court concluded that the United States lacked the authority in U.S. law to give effect to a judgment of the International Court of Justice relating to U.S. obligations under the Vienna Convention on Consular Relations. The Foreign Relations Committee has previously stressed its view that it is important that the United States comply with its treaty obligations, and has observed that the committee generally does not recommend that the Senate give advice and consent to treaties unless it is satisfied that the United States has sufficient domestic legal authority to implement them. With these considerations in mind, please indicate what authorities Federal and State governments will rely on to implement the various obligations the United States would assume upon becoming party to this treaty.

Answer. The United States currently has all necessary authority to implement the Treaty. Please see pp. 2–8 of Treaty Transmittal package for a description of such authorities. As described in that package, the Treaty's core obligations are to be implemented primarily using USDA and USAID authorities, such as the authority to operate the National Germplasm System found in 7 U.S.C. § 5841.

*Question.* Article 3 of the Treaty specifies that the Treaty relates to plant genetic resources "for food and agriculture." Are there specific other uses for plant genetic resources that this scope was intended to exclude? Would the Treaty's provisions apply to energy-related uses of plant genetic resources?

Answer. Access to plant genetic resources via the Multilateral System is to be "provided solely for the purpose of utilization and conservation for research, breeding, and training for food and agriculture, provided that such purpose does not include chemical, pharmaceutical and/or other nonfood/feed industrial uses." See Article 12.3(a). Energy-related uses of plant genetic resources are understood to be a nonfood/feed industrial use, and the Multilateral System would not provide for access to the plant genetic resource for research, breeding and training for such an industrial use.

*Question.* Article 9 of the Treaty addresses "Farmers Rights."

- Please indicate whether the administration interprets Article 9 of the Treaty to require States Parties to afford particular rights to farmers under their domestic laws.
- Please indicate what steps the administration intends to take to implement Article 9, and what authorities it would rely upon.

Answer. No; the Treaty does not require States Parties to afford any particular rights to farmers under domestic laws. Instead it specifically envisions that each Party would define its own particular measures in this regard. The United States already recognizes the importance of consultation and recognition as contemplated by this article, including in a variety of national and state laws, regulations, and orders, including contract laws, unfair competition laws, intellectual property laws, and Executive Order 13175 (November 6, 2000) "Consultation and Coordination with Indian Tribal Governments." Further, USDA has long conveyed extensive non-monetary benefits to farmers through land grant universities and extension services authorized under, inter alia, 7 U.S.C. §§301 et. seq., 322 et. seq. and 341 et seq. USDA also provides services specifically to indigenous communities through, inter alia, Title V of P.L. 103-382 (Oct. 20, 1994); Title XVI, §1677, P.L. 101-64 (1990 Farm Bill); 7 U.S.C. § 3241 and 20 U.S.C. § 1059d.

*Question.* Please indicate whether the administration intends that Article 9, or any other provision in the Treaty, would confer private rights enforceable in U.S. courts if the United States became a party to the Treaty.

Answer. Neither Article 9 nor any other provision of the Treaty would confer directly enforceable rights in U.S. courts.

*Question.* The transmittal package for the Treaty indicates that the United States interprets Article 12 of the Treaty as not diminishing the availability or exercise of intellectual property rights under national laws.

- Is the administration aware of any instances in which parties to the Treaty have expressed contrary interpretations of Article 12?
- Is the administration aware of any practice under the Treaty that confirms or contradicts the interpretation of the United States on this issue?

Answer. We are not aware of any instances in which Parties have expressed contrary interpretations of Article 12 nor are we aware of any practices under the Treaty that contradict our interpretation of Article 12. Consistent with the United States interpretation of Article 12, a number of Parties have submitted declarations that plant genetic resources for food and agriculture or their genetic parts or components which have undergone innovation may be subject to intellectual property rights, provided that the criteria relating to such rights are met.

*Question.* Article 11.2 of the Treaty provides that the Multilateral System established under the Treaty "shall include all plant genetic resources for food and agriculture listed in Annex I that are under the management and control of the Contracting Parties and in the public domain." Please indicate to what extent, if any, this Article would require the United States to make available plant genetic resources not currently made available under the U.S. National Plant Germplasm System.

Answer. There is no requirement to make any genetic resources available beyond those already made available by the National Plant Germplasm System.

*Question.* Article 13.2(a) of the Treaty provides for parties to the Treaty to make available specified information about plant genetic resources included in the Multilateral System established under the Treaty. Please indicate whether these provisions would obligate the United States to make publicly available information about plant genetic resources that it does not currently make available in connection with the operation of the U.S. National Plant Germplasm System.

Answer. There are no requirements to make any information available beyond that already freely distributed by the U.S. Department of Agriculture and the National Plant Germplasm System. The Treaty language exempts confidential information. The requirement to make information available is also subject to national law, such as legal privileges and the Trade Secrets Act 18 U.S.C. § 1905.

*Question.* Please indicate what steps the administration intends to take to implement the provisions of Article 13.2(b) of the Treaty addressing access to and transfer of technology.

Answer. The U.S. Department of Agriculture's existing programs and practices are consistent with Article 13.2(b) of the Treaty. The National Plant Germplasm System and the Germplasm Resources Information Network will continue to provide germplasm and related information freely. Joint bilateral research projects between USDA and its counterparts in Party countries will continue, as long as they continue to address priorities of the United States and its counterparts, and if funds continue to be available.

*Question.* Under Article 13.2(d) of the Treaty, the standard Material Transfer Agreement (MTA) includes a requirement that a recipient who commercializes a product that includes material accessed under the Treaty must, under certain circumstances, pay to a Trust Account established under the Treaty “an equitable share of the benefits arising from the commercialization of that product.” According to the transmittal package for the Convention, the MTA adopted by Treaty Governing Body “includes a payment level of 1.1 percent of gross sales of a product incorporating material from the Multilateral System minus a standard deduction of 30 percent.”

a. What factors went into the Governing Body’s decision to set the required payment at this level?

b. How does this required payment compare to the terms under which U.S. entities accessed plant genetic resources from foreign sources prior to the entry into force of the Treaty?

c. How much revenue has been generated for the Trust Account to date from payments made pursuant to this provision of the MTA? How much revenue does the administration expect such payments to generate over the life of the Treaty?

*Answer.*

a. The payment level defined in the Treaty’s standard material transfer agreement (SMTA) was determined through a multilateral negotiation process in which the United States participated. Article 13.2(d)(iii) of the Treaty requires the Governing Body to “determine the level, form, and manner of the payment, in line with commercial practice.” The payment level is considered by the U.S. seed industry to be reasonable and consistent with existing commercial practice with respect to current industry royalty rates. Joining the Convention would give the United States a veto over any attempt to raise the payment level established, which currently works out to be 0.77 percent of gross sales.

b. Some materials under the control of Treaty Parties have not been available to U.S. entities under any terms. The Treaty will guarantee access to such materials that might not otherwise be available. Under the terms of the SMTA, payment is not required for access. Payment is required when a product is commercialized, but only if that product is not freely available for further research and breeding. The SMTA grants recipients the right to commercialize products under a fixed royalty rate that the United States and other governments have prenegotiated. U.S. entities may decide whether this rate is reasonable for a particular product prior to accessing materials in the Multilateral System. Moreover, U.S. ratification of the Treaty will not affect whether U.S. entities accessing material from the Multilateral System must pay such a rate, because foreign seed banks are already requiring acceptance of the SMTA terms as a condition of access to such material. In other words, the royalty payment would arise under private contracts that are already in widespread use, and would not depend on whether the United States has joined the Treaty.

c. To date, there have been no payments to the Trust Account. The Treaty entered into force in June 2004. Scientific research and plant breeding require years to accomplish their goals, and only a small percentage of such efforts yields any commercial products. Thus, there will likely be a lengthy “lag time” between the date of initial access to plant genetic resources for food and agriculture from the Multilateral System and the date of commercialization of any products resulting from that research and development. Consequently, no revenue has been generated to date for the Trust Account from payments made pursuant to this provision of the MTA. We are uncertain how much revenue such payments will generate, but forecast them to be in line with what might be expected, based on current commercial practice, from payments generated by licensing of unimproved genetic resources from public-sector sources to U.S. private-sector companies. The Treaty anticipates generating other revenues through voluntary contributions to the Trust from both public and private sectors.

*Question.* Article 13.2(d)(ii) of the Treaty provides that the Treaty’s Governing Body “may, from time to time, review the levels of payment [provided for in the MTA] with a view to achieving a fair and equitable sharing of benefits.”

a. Under what circumstances would the administration support a decision by the Governing Body to change the payment level referred to in Article 13.2(d)(ii)?

b. Does the administration intend to consult with the Congress before supporting a decision by the Governing Body to change the payment level referred to in Article 13.2(d)(ii)?

*Answer.*

a. If U.S. stakeholders supported a change in the payment level referred to in Article 13.2(d)(ii), the United States would support a change. To date, all indications are that the payment level is consistent with existing commercial practice.

b. The U.S. would consult as appropriate with all interested stakeholders, including Congress, on this matter.

*Question.* Please provide the amount of the annual budget for the most recent year approved by the Treaty's Governing Body, and for the immediate two previous years.

*Answer.* The approved operating budgets for 2008, 2009, 2010, and 2011 are \$1,844,426; \$2,826,885; \$2,244,366; and \$2,821,566 respectively.

*Question.* Article 13.3 of the Treaty provides that "benefits arising from the use of plant genetic resources for food and agriculture that are shared under the multilateral system should flow primarily, directly and indirectly, to farmers in all countries, especially in developing countries, and countries with economies in transition, who conserve and sustainably utilize plant genetic resources for food and agriculture." Does the administration expect that U.S. farmers will share in the benefits referred to in Article 13.3 of the Treaty? If so, how will such benefits be allocated and distributed to U.S. farmers?

*Answer.* It is expected that plant genetic resources made available under the Treaty's Multilateral System will be incorporated into U.S. public and private-sector research and breeding programs. We do not anticipate a need for an allocation or distribution scheme as the benefits in question are general in nature. For example, U.S. farmers will benefit by having access to improved varieties, developed by those breeding programs, that are resistant to emerging diseases, to environmental stresses such as drought, or which have increased product value and/or nutritional content.

*Question.* To what purposes does the administration expect revenues accruing to the Trust Account referred to in paragraph 19.3(f) of the Treaty will be put? Given that decisions on the use of such funds require consensus of the Treaty's Parties, and thus could not be approved over U.S. objections, what considerations will guide the administration's policy on the appropriate uses of such funds?

*Answer.* Revenues will be used primarily for capacity-building activities that support the goals of conservation and sustainable use of plant genetic resources that are critical for international food security. The distribution of the funds in the Trust Account will be subject to a funding strategy, which is reviewed and approved by the Governing Body (i.e., by consensus of the Parties to the Treaty). The administration's policy on the appropriate uses of the funds will include consideration of consistency with the Treaty's objectives, as well as efficiency, effectiveness, and accountability in the use of funds.

*Question.* Article 18.4(d) of the Treaty provides that states parties to the Treaty "agree [] to undertake, and provide financial resources for national activities for the conservation and sustainable use of plant genetic resources for food and agriculture in accordance with its national capabilities and financial resources. The financial resources provided shall not be used to ends inconsistent with this Treaty, in particular in areas related to international trade in commodities."

a. Does the administration interpret this Article to require the United States to provide specific amounts of funding available for the programs described?

b. What steps does the administration plan to take to implement this Article?

c. What restrictions on existing U.S. programs would be imposed by the Treaty's requirement that financial resources "not be used to ends inconsistent with this Treaty, in particular in areas related to international trade in commodities?"

d. Would the Treaty's requirement that financial resources "not be used to ends inconsistent with this Treaty, in particular in areas related to international trade in commodities" apply to funding for programs implemented by state or local governments in the United States? Are any such state and local programs currently implemented in a manner consistent with this requirement?

*Answer.*

a. No, Article 18.4(d) does not obligate Parties to contribute specific amounts of financial resources for national activities for the conservation and sustainable use of plant genetic resources. Further, there are no assessed contributions from Parties to the Treaty.

b. Existing U.S. practice is consistent with Article 18.4(d).

c. Existing U.S. practice is consistent with Article 18.4(d).

d. No, 18.4(d) would not apply to funding for programs implemented by state or local governments. Furthermore, the few state and local programs devoted to conservation and sustainable use of plant genetic resources, such as local crop genebanks, are currently implemented in a manner consistent with the Treaty.

*Question.* Article 18.4(f) of the Treaty envisions that activities undertaken pursuant to the Treaty will be funded, in part, by voluntary contributions from States Parties to the Treaty. Please indicate whether the administration would intend to provide any voluntary contributions toward the Treaty's budget if the United States became Party to the Treaty. Please indicate the amount of any such envisioned contributions.

*Answer.* There are no plans to make voluntary financial contributions toward the Treaty's budget at this time.

*Question.* Under Article 22 of the Treaty, Parties have the option of accepting compulsory dispute settlement in the form of arbitration or submission of disputes to the International Court of Justice. Please indicate whether the executive branch recommends that the United States submit to binding dispute resolution under either or both of these mechanisms.

*Answer.* No; the administration does not make such a recommendation.

*Question.* Article 23 of the Treaty establishes rules applicable to amending the Treaty and its annexes. What process does the executive branch intend to follow with respect to considering any such amendments? Does the executive branch intend to submit any such amendments to the Senate for advice and consent?

*Answer.* While we would anticipate that ordinarily any amendment to the main body of the Treaty would warrant the advice and consent of the Senate, our expectation is that amendments to Annex I, which lists crops and forages covered by the Multilateral System, would be procedural and technical in nature and would not, in the normal course, require the advice and consent of the Senate. If, however, a proposed amendment to Annex I were to go beyond the current mandate of the Annex and raise more substantive issues, the executive branch would consult with the committee in a timely manner regarding the question of whether advice and consent is warranted. In the case of Annex II, as noted in an earlier question, the executive branch does not recommend that the United States submit to binding dispute resolution under Article 22 of the Treaty and thus it is anticipated that amendments to Part I of Annex II would, even if accepted, have no legal effect on the United States. An amendment to Part II of Annex II, which deals with conciliation, could have an effect on the United States and the executive branch would consult with the committee on whether such an amendment would warrant the advice and consent of the Senate.

