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EXPLANATION OF PROPOSED INCOME TAX TREATY BETWEEN THE UNITED STATES AND THE REPUBLIC OF MALTA

PREPARED FOR THE USE OF THE

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CONTENTS

INTRODUCTION

This pamphlet provides an explanation of the proposed income tax treaty between the United States and the Republic of Malta ("Malta"). The proposed treaty was signed on March 21, 1980, and was amplified by an Exchange of Notes signed the same day. No similar treaty between the two countries is in force at the present time. The proposed treaty has been scheduled for a public hearing on September 24, 1981, by the Senate Committee on Foreign Relations.

The proposed treaty is similar to other recent U.S. income tax treaties, the U.S. model income tax treaty, and the model income tax treaty of the Organization of Economic Cooperation and Development (OECD). However, there are certain deviations from the model to reflect Malta's status as a developing country, and the United Nation's model for tax treaties between developed and developing countries.

The first part of the pamphlet is a summary of the principal provisions of the proposed tax treaty. The second part provides an overview of U.S. tax rules relating to international trade and investment and U.S. tax treaties in general. This is followed by a detailed, article-by-article explanation of the proposed treaty.

I. SUMMARY

In General

The principal purpose of the proposed income tax treaty between the United States and Malta is to reduce or eliminate double taxation of income earned by citizens and residents of either country from sources within the other country and to prevent avoidance or evasion of the income taxes of the two countries. The proposed treaty is intended to promote closer economic cooperation between the two countries and to eliminate possible barriers to trade caused by overlapping taxing jurisdictions of the two countries. It is also intended to enable countries to cooperate in preventing avoidance and evasion of taxes.

As in other U.S. tax treaties, these objectives are principally achieved by each country agreeing to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other. For example, the treaty contains the standard tax treaty provision that neither country will tax the business income derived from sources within that country by residents of the other unless the business activities in the taxing country are substantial enough to constitute a permanent establishment or fixed base (Articles 7 or 14). Similarly, the treaty contains the standard "commercial visitor" exemptions under which residents of one country performing personal services will not be required to file tax returns and pay tax in the other unless their contacts with the other exceed certain specified minimums (Articles 14, 15, 17 and 18). Also, the proposed treaty provides that dividends, interest, royalties, capital gains and certain other income derived by residents of either country from sources within the other generally may be taxed by both countries (Articles 10, 11, 12, 13, and 23). Generally, however, dividends, interest, and royalties received by residents of one country from sources within the other are to be taxed at reduced rates by the country of source (Articles 10, 11, and 12), and capital gains are to be taxed on a restricted basis (Article 13).

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

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

The treaty differs from most U.S. treaties by treating a U.S. citizen as a U.S. resident. This extends coverage to U.S. citizens residing outside the United States.

The treaty also contains standard nondiscrimination provisions and provides for exchanges of information and administrative cooperation between the tax authorities of the two countries to avoid double taxation and prevent fiscal evasion with respect to income taxes.

The proposed treaty departs from the U.S. model in a few respects to reflect Malta's status as a developing country. It broadens the definition of the term permanent establishment to include a building or construction site, etc. that lasts for more than 183 days out of 12 months, and related supervisory services. The withholding rate at source on interest and royalties is limited to 12.5 percent. The U.S. model exempts that income from tax, but the position in the model is rarely achieved, at least with developing countries.

The proposed treaty also contains a special anti-abuse provision covering shipping to take into account special tax treatment accorded certain foreign owned shipping companies by Malta.

Specific Issues

The proposed treaty presents the following specific issues:

1. Whether departures from present U.S. treaty policy as expressed in the U.S. model to reflect Malta's status as a developing country are appropriate? As described above, the proposed treaty contains a number of provisions that deviate from the U.S. model by increasing source basis, as opposed to residency basis, taxation. For example, the proposed treaty would treat a building or construction site maintained in a country for 183 days in a 12-month period and supervising services as a permanent establishment. (See Article 5. Permanent Establishment.)

2. Whether the provision in the proposed treaty intended to prevent treaty shopping by persons engaged in international shipping is adequate? In general, the proposed treaty would deny certain Maltese companies not taxed by Malta, the exemption from United States on shipping profits. However, the Exchange of Notes says that the United States will only tax those profits to the extent they are attributable to a United States permanent establishment. As shipping companies often do not have permanent establishments in the United States, the effect of the anti-abuse measure is unclear.

3. Whether the United States should expand its tax treaty network to jurisdictions with which the United States has only minimal economic contacts? Arguably, an expansion by an appropriate treaty is beneficial because it can encourage economic relations and establish a framework for tax administration cooperation between the countries. On the other hand, a question is raised as to the use of resources, and the ability to administer an expanded treaty network.

II. OVERVIEW OF UNITED STATES TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND TAX TREATIES

A. United States Tax Rules

The United States taxes U.S. citizens and residents and U.S. corporations on their worldwide income. The United States taxes nonresident alien individuals and foreign corporations on their U.S. source income which is not effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "noneffectively connected income"). They are also taxed on their U.S. source income and certain limited classes of foreign source income which is effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "effectively connected income.")

Income which is effectively connected with the conduct of a trade or business in the United States is subject to tax at the normal graduated rates on the basis of net taxable income. Deductions are allowed in computing effectively connected taxable income, but only if and to the extent they are connected with income which is effectively connected.

United States source fixed or determinable, annual or periodical income (e.g. interest, dividends, rents, salaries, wages, premiums, annuities) which is noneffectively connected income and which is received by a nonresident alien or foreign corporation is subject to tax at a rate of 30 percent of the gross amount paid. This gross tax on fixed or determinable income is often reduced or eliminated in the case of payments to residents of countries with which the United States has an income tax treaty. The 30-percent (or lower treaty rate) tax imposed on U.S. source noneffectively connected income paid to foreign persons is collected by means of withholding (hence they are often called withholding taxes).

Certain exemptions from the gross tax are provided. Bank account interest is defined as foreign source interest and, therefore, is exempt. Exemptions are also provided for certain original issue discount and for income of a foreign government from investments in U.S. securities. Our treaties also provide for exemption from tax in certain cases.

Net U.S. source capital gains are also subject to the 30 percent tax but only in the case of a nonresident alien who is present in the United States for at least 183 days during the taxable year. Otherwise foreign corporations and nonresident aliens are only subject to U.S. taxation (at the graduated rates) on those capital gains that are effectively connected with the conduct of a trade or business in the United States.

Prior to June 18, 1980, noneffectively connected capital gains from the sale of U.S. real estate were subject to U.S. taxation only if received by a nonresident alien who was present in the United States for at least 183 days. However, in the Omnibus Reconciliation Act of 1980 a provision was added to the Internal Revenue Code that the sale, exchange or disposition of U.S. real estate by a foreign corporation or a nonresident alien would be taxed as effectively connected income. Also taxable under the legislation are dispositions by foreign investors of their interests in certain U.S. corporations and other entities whose assets include U.S. real property and associated personal property.

The source of income received by nonresident aliens and foreign corporations is determined under special rules contained in the Internal Revenue Code. Under these rules interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation are considered U.S. source income. However, if the U.S. corporation derives more than 80 percent of its gross income from foreign sources, then dividends and interest paid by such corporation will be foreign source rather than U.S. source. Conversely, dividends and interest paid by a foreign corporation, which has at least 50 percent of its income as effectively connected income, are U.S. source to the extent of the ratio of its effectively connected income to total income.

Rents and royalities paid for the use of property in the United States is considered U.S. source income. The property use can be either tangible property or intangible property (e.g., patents, secret processes and formuals, franchises and other like property).

Since it taxes U.S. persons on their worldwide income, double taxation of income can arise because income earned abroad by a U.S. person will be taxed by the country in which the income is earned and also by the United States. The United States seeks to mitigate this double taxation by allowing U.S. taxpayers to credit their foreign income taxes against the U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that insures that the foreign tax credit only offset the U.S. tax on foreign source income. This limitation is computed on a world-wide consolidated basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income. Separate limitations on the foreign tax credit are provided for certain interest, DISC dividends, and oil income.

A U.S. corporation that owns 10 percent or more of the stock of a foreign corporation may credit foreign income taxes paid or deemed paid by that foreign corporation on earnings that are received as dividends. These deemed paid taxes are included in total foreign taxes paid for the year the dividend is received and go into the general pool of taxes to be credited.

B. United States Tax Treaties—In General

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. To a large extent, the treaty provisions designed to carry out these objectives supplement Code provisions having the same objectives, modifying the generally applicable statutory rules with provisions which take into account the particular tax system of the treaty country. Given the diversity of tax systems in the world, it would be virtually impossible to develop in the Code rules which unilaterally would achieve these objectives for all countries.

Notwithstanding the unilateral relief measures of the United States and our treaty partners, double taxation might arise because of differences in source rules between the United States and the other country. Likewise, if both countries consider the same deduction allocable to foreign sources, double taxation can result. Significant problems arise in the determination of whether a foreign tax qualifies for the U.S. foreign tax credit. Also, double taxation may arise in those limited situations where a corporation or individual may be treated as a resident of both countries and be taxed on a worldwide basis by both.

In addition, there may be significant problems involving "excess" taxation—situations where either country taxes income received by nonresidents at rates which exceed the rates imposed on residents. This is most likely to occur in the case of income taxed at a flat rate on a gross income basis. (Most countries, like the United States, generally tax domestic source income on a gross income basis when it is received by nonresidents who are not engaged in business in the country.) In many situations the gross income tax is imposed at a rate which exceeds the tax which would have been paid under the net income tax system applicable to residents.

Another related objective of U.S. tax treaties is the removal of barriers to trade, capital flows, and commercial travel caused by overlapping tax jurisdictions and the burdens of complying with the tax laws of a jurisdiction where the contacts with, and income derived from, that jurisdiction are minimal.

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

Treaties first seek to eliminate double taxation by defining the term "resident" so that an individual or corporation generally will not be subject to tax as a resident by each of the two countries. The treaty also porvides that neither country will tax business income derived from sources within it by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a branch or other permanent establishment or fixed base. The treaties contain commercial visitation exemptions under which individual residents of one country performing personal services in the other will not be required to file tax returns and pay tax in that other country unless their contacts exceed certain specified minimums, normally presence for a set number of days or earnings of over a certain dollar amount.

The treaties deal with passive income such as dividends, interest, or royalties, or capital gains, from sources within one country derived by residents of the other country by either providing that they are taxed only in the country of residence or by providing that the withholding tax generally imposed on those payments is reduced. As described above, the U.S. generally imposes a 30 percent tax and seeks to reduce this tax in some cases on some income to zero in its tax treaties.

In its treaties, the United States, as a matter of policy, retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect, and provides this in the treaties in the so-called "savings clause". Double taxation can therefore still arise. Double taxation can also still arise because most countries will not exempt passive income from tax at source.

This double taxation is further mitigated either by granting a credit for income taxes paid to the other country, or by, in the case of some of our treaty partners, by providing that income will be exempt from tax in the country of residence. The United States provides in its treaties that it will allow a credit against United States tax for income taxes paid to the treaty partners, subject to the limitations of U.S. law. An important function of the treaty is to define the taxes to which it applies to provide that they will be considered creditable income taxes for purposes of the treaty.

The treaties also provide for administrative cooperation between the countries. This cooperation includes a competent authority mechanism to resolve double taxation problems arising in individual cases, or more generally, by consultation between tax officials of the two governments.

Administrative cooperation also includes provision for an exchange of tax-related information to help the United States and its treaty partners administer their tax laws. The treaties generally provide for the exchange of information between the tax authorities of the two countries where such information is necessary for carrying out the provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information not obtainable under its laws or in the normal course of its administration, or to supply information which would disclose trade secrets or other information the disclosure of which would be contrary to public policy.

The provisions generally result in an exchange of routine information, such as the names of U.S. residents receiving investment income. The IRS (and the treaty partner's tax authorities) also can request specific tax information from a treaty partner. This can include information to be used in a criminal investigation or prosecution.

III. EXPLANATION OF PROPOSED TAX TREATY

A detailed, article-by-article explanation of the proposed income tax treaty between the United States and Malta is presented below.

Article 1. Personal Scope

The proposed treaty applies generally to residents of the United States and to residents of Malta, with specific exceptions designated in other articles. This follows other U.S. income tax treaties, the U.S. model income tax treaty, and the OECD model income tax treaty.

The proposed treaty also provides that it does not restrict any benefits accorded by internal law or any other agreement between the United States and Malta—that is, the treaty only applies where it benefits taxpayers.

The proposed treaty contains the "saving clause" contained in all U.S. income tax treaties which provides, with specified exceptions, that the treaty is not to affect the taxation by the United States of its citizens and residents or the taxation by Malta of its citizens and residents. Consequently, unless otherwise specifically provided in the proposed treaty, the United States will continue to tax its citizens who are residents of Malta. Residents for purposes of the treaty (and thus for purposes of the saving clause) include corporations and other entities as well as individuals (Article 4. Fiscal Residence).

Under section 877, a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of U.S. income tax, will, in certain cases, be subject to tax for a period of ten years following the loss of citizenship. The treaty does not contain the standard provision found in the U.S. model, and most recent treaties, specifically retaining the right to tax former citizens. However, the article is intended to cover former citizens to reserve the right of the U.S. to tax former citizens under section 877. This is the position of the Internal Revenue Service. See Rev. Rul. 79–152, 1979–1 C.B. 237.

Exceptions to the saving clause are provided for the benefits conferred by the articles dealing with relief from double taxation (Article 24) nondiscrimination (Article 25) and mutual agreement procedures (Article 26). Thus, the benefits of those articles will be conferred by each country on its own citizens and residents as well as the citizens and residents of the other country. In addition, the benefits conferred by the articles dealing with the taxation of income received by government employees (Article 20), teachers (Article 21), students and trainees (Article 22), and diplomatic and consular officials (Article 28) are to be granted by each country to its residents provided those residents are neither citizens of, nor have immigrant status in that country.

Consequently, except for the exceptions to the saving clause set forth above, U.S. citizens and residents generally benefit under the treaty as the result of the agreement by Malta to reduce its rate of tax on their

66-273 O - 81 - 2

income or exempt their income from tax rather than as the result of reductions in tax or exemptions by the United States. Even in this situation, if the tax which is foregone by Malta could have otherwise been claimed in full by the U.S. taxpayers as a foreign tax credit, the real beneficiary of the reduction or elimination of the Maltese tax would, as a practical matter, be the U.S. Treasury rather than the U.S. taxpayer. Similarly, except as noted above, Maltese citizens and residents benefit under the treaty only to the extent that the United States agrees to reduce its tax on their income or to exempt their income from tax.

Article 2. Taxes Covered

The proposed treaty applies to taxes on income which are imposed by either country. In the case of the United States the proposed treaty applies to the Federal income taxes imposed under the Internal Revenue Code and to the excise taxes imposed on insurance premiums paid to foreign insurers (section 4371) [1] and with respect to private foundations (sections 4940 and 4948). (The effect of covering the insurance premium excise tax is described in the discussion of Article 7, Business Profits.) Like the U.S. model, the treaty preserves the right of the United States to apply its accumulated earnings tax and personal holding company tax in certain cases.

In the case of Malta, the treaty applies to the income tax, including prepayments of tax made by deduction at source or otherwise. Under Article 24(1) (Relief From Double Taxation), these taxes are designated as income taxes for purposes of the U.S. foreign tax credit.

The proposed treaty also contains a provision generally found in U.S. income tax treaties to the effect that it will apply to substantially similar taxes which either country may subsequently impose. Each country is obligated under the treaty to notify the other of any significant changes it makes in its tax laws and of any official published material concerning the treaty, including explanations, regulations, rulings, and judicial determinations.

Additionally, the nondiscrimination provisions (Article 25) of the treaty apply to all taxes of every kind imposed at the national, state, or local level by the United States or Malta.

Article 3. General Definitions

Certain of the standard definitions found in most U.S. income tax treaties are contained in the proposed treaty.

Under the proposed treaty, the term "United States" means the United States of America, but does not include Puerto Rico, the Virgin Islands, Guam or any other possession or territory of the United States. Accordingly, income from sources within those jurisdictions is not covered. When used in the geographical sense the term "United States" includes the territorial sea of the United States and in certain limited situations relating to the exploration for, and exploitation of, natural resources, the seabed and subsoil of the submarine areas adjacent to the coast of the United States. The term "Malta" means the Republic of Malta and when used in a geographical

[1] All section references are to the Internal Revenue Code of 1954, unless otherwise cited.

sense includes the Maltese islands, the territorial sea of the Republic of Malta, and, in certain limited situations, relating to the exploration for, and exploitation of natural resources, seabed and subsoil of the submarine areas adjacent to the coast of the Republic of Malta.

A "national" of either country is defined to include both a citizen of that country and also any legal entity such as a corporation, trust, estate, partnership, or association which is established under the laws of that country. A "company" is defined as a corporation or other entity treated as a corporation for tax purposes. An enterprise of a country is defined as an enterprise carried on by a resident of that country. Although the treaty does not define the term "enterprise," it would have the same meaning that it has in other U.S. tax treaties—the trade or business activities undertaken by an individual, partnership, corporation, or other entity.

The proposed treaty also contains the standard provision that unless the context otherwise requires or the competent authorities of the two countries establish a common meaning, all terms are to have the meaning which they have under the applicable tax laws of the country applying the treaty.

Article 4. Fiscal Residence

The benefits of the proposed treaty generally are available only to a resident of one of the countries. Under the treaty, a person (either an individual or an entity such as a corporation or partnership) is considered to be a resident of a country if, under the laws of that country, the person is subject to taxation by that country because it is his country of domicile, residence, citizenship, place of management, place of incorporation, or by reason of other criterion of a similar nature. A person will not be considered to be a resident of a country if he is only taxable on his income from sources within that country. A partnership, estate, or trust will be considered to be a resident of a country only to the extent that the income it derives is subject to tax, either in its hands or in the hands of its partners or beneficiaries, as the income of a resident of the country.

This provision of the proposed treaty is generally based on the fiscal domicile article of the U.S. model and OECD model tax treaties and is similar to the provisions found in other U.S. tax treaties. However, a significant difference between the definition of resident in this treaty and the definition in other recent U.S. income tax treaties, and consequently a significant difference in the coverage of the treaty, is that a U.S. citizen is considered a U.S. resident for purposes of the treaty. As a result, U.S. citizens residing overseas (in countries other than Malta) are entitled to the benefits of the treaty as U.S. residents. This result reflects U.S. treaty policy as expressed in the U.S. model, but is achieved in very few treaties.

Since Malta generally taxes on the basis of residence rather than citizenship, this broadened definition of resident does not benefit citizens of Malta who are not Maltese residents. However, Malta does tax certain of its nationals who work overseas for the Maltese Government (or its instrumentalities), and in accord with U.S. policy, a special rule is provided under which these individuals and their families are treated as residents of Malta entitled to the benefits of the treaty.

A set of rules is provided to determine residence in the case of a person who, under the basic treaty definition, would be considered to be a resident of both countries (e.g., a U.S. citizen who is resident in Malta). In the case of a dual resident individual, the individual will be deemed for all purposes of the treaty to be a resident of the country in which he has a permanent home (where an individual dwells with his family), his center of vital interests (his closest economic and personal relations), his habitual abode, or his citizenship. If the residence of an individual cannot be determined by these tests, the competent authorities of the countries will settle the question by mutual agreement.

A corporation that is a dual resident of both the United States and Malta because of Article 4 and which is created or organized under the laws of either country (or a political subdivision), will be treated as a resident of the country in which organized. The residence of a dual resident person, other than an individual or a corporation (e.g., a dual resident partnership, trust, or estate), and the mode of application of the treaty to that person will be be determined by the competent authorities.

The proposed treaty also has a rule regarding income arising in one country which, under the treaty, is exempt from tax (or subject to a reduced treaty rate) in that country and which is not subject to tax in the other country until it is remitted. The proposed treaty provides that in such situations the income is only relieved from tax under the treaty to the extent that the income is remitted to the other country in the year it accrues or in the following year. (The U.S. model extends treaty benefits only to income remitted in the year it accrues.) If the income is not remitted within that time period, the income will never be relieved from tax in the first country under the treaty, and when the income is ultimately remitted to the other country the taxpayer will have to look to Article 24 for relief from double taxation. Malta does, in some cases, tax on a remittance basis.

Article 5. Definition of Permanent Establishment

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

The permanent established concept is one of the basic devices used in income tax treaties to avoid double taxation. Generally, an enterprise that is a resident of one country is not taxable by the other country on its business profits unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the permanent establishment concept is used to determine whether the reduced rates of, or exemption from, tax provided for dividends, interest, and royalties are applicable, or whether those amounts will be taxed as business profits. United States taxation of business profits is discussed under Article 7 (Business Profits).

In general, a permanent establishment is a fixed place of business through which a resident of one country engages in business in the other country. A permanent establishment includes a place of management, a branch, an office, a factory, a workshop, or a mine, an oil or gas well, a quarry, or other place of extraction of natural resources. It also includes any building site, construction or installation project, or an installation or drilling rig or ship used for the exploration or development of natural resources, but only if the site, project, etc., lasts for more than 183 days in any 12-month period (except for taxable years where the activity continued for less than 30 days in that taxable year). Supervisory activities connected with a building site, construction or installation project activities also give rise to a permanent establishment. Supervisory services are not usually found in U.S. treaties and the 183-day period is shorter than the 12-month period usually provided. This broadening of the definition of permanent establishment reflects Malta's status as a developing country, and is generally consistent with the United Nations model for income tax treaties between developed and developing countries.

This general rule is modified to provide that a fixed place of business which is used solely for any or all of a number of specified activities will not constitute a permanent establishment. These activities include the use of facilities for storing, displaying, or delivering merchandise belonging to the resident or for the maintenance of a stock of goods belonging to the resident for storage, display, or delivery, or for processing by another person. These activities also include the maintenance of a fixed place of business for the purchase of goods or merchandise or the collection of information, for advertising or scientific research, or any other preparatory or auxiliary activities for the resident.

If a resident of one country maintains an agent in the other country who has, and regularly exercises the authority to enter into contracts in that other country in the name of the resident, then the resident will be deemed to have a permanent establishment in the other country with respect to the activities which the agent undertakes on its behalf. This rule does not apply where the contracting authority is limited to those activities (described above) such as storage, display, or delivery of merchandise which are excluded from the definition of permanent establishment. The proposed treaty contains the usual provision that the agency rule will not apply if the agent is a broker, general commission agent, or other agent of independent status acting in the ordinary course of its business.

The determination of whether a company of one country has a permanent establishment in the other country is to be made without regard to the fact that the company may be related to a resident of the other country or to a person who engages in business in that other country. The relationship is thus not relevant; only the activities of the company being tested are relevant.

Article 6. Income from Immovable Property (Real Property)

The proposed treaty provides that income from real property may be taxed in the country where the real property is located. For purposes of the treaty, real property will generally have the meaning provided under the laws of the country where the property is located, but will in any case include property which is accessory to real property rights, usufruct of real property, and rights to certain payments regarding natural resources. Ships, boats, and aircraft will not be considered real property.

Income from real property includes income from the direct use or renting of the property. It also includes royalties and other payments in respect of the exploitation of natural resources (e.g., oil wells). It does not include interest on loans secured by real property.

Under Article 13 (Capital Gains), gains on the sale, exchange, or other disposition of real property may also be taxed by the country where the property is located. Also, gain from the disposition of stock in a company whose assets consist, directly or indirectly, principally of real estate may be taxed in the country in which the company's real estate is located.

Generally, gain realized by a nonresident alien or a foreign corporation from the sale of a capital asset is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S. trade or business or, in the case of a nonresident alien, he is physically present in the United States for at least 183 days in the taxable year. However, under the Foreign Investment in Real Property Tax Act of 1980, as amended, a nonresident alien or foreign corporation is taxed by the United States on gain from the sale of U.S. real estate, and gain from the sale of stocks in U.S. real property holding corporations, as if gain was effectively connected with a trade or business conducted in the U.S. The real estate provision of Article 13 would not in any way restrict the right of the United States to tax the gain from the sale of U.S. real estate and stock of U.S. real property holding corporations under the provisions of the 1980 legislation or any similar but later enacted legislation. It also retains the right of the U.S. to impose relevant reporting or withholding requirements.

Article 7. Business Profits

U.S. Code rules.—United States law separates the business and investment income of a nonresident alien or foreign corporation. A nonresident alien or foreign corporation is subject to a flat 30-percent, or lower, treaty rate of tax on its U.S. source income if that income is not effectively connected with the conduct of a trade or business within the United States. The regular individual or corporate rates apply to U.S. source income which is effectively connected with the conduct of a trade or business within the United States.

The taxation of income as business or investment income varies depending upon whether the income is United States or foreign. U.S. source periodic income, such as interest, dividends, rents, wages, and capital gains is effectively connected with the conduct of a trade or business within the United States only if the asset generating the income is used in or held for use in the conduct of the trade or business, or if the activities of the trade or business were a material factor in the realization of the income. All other U.S. source income is treated as effectively connected income.

Foreign source income is effectively connected income only if the foreign person has an office or other fixed place of business in the United States and the income is attributable to that place of business. Only three types of foreign source income can be effectively connected income: rents and royalties derived from the active conduct of a licensing business; dividends, interest, or gain from stock or debt derived in the active conduct of a banking, financing or similar business in the

United States; and certain sales income attributable to a United States sales office.

Except in the case of a dealer, the trading in stocks, securities or commodities in the United States for one's own account does not constitute a trade or business in the United States and accordingly income from those activities is not taxed by the United States as business income. This concept includes trading through a U.S. based employee, a resident broker, commission agent, custodian or other agent or trading by a foreign person physically present in the United States.

Proposed treaty rules.—Under the proposed treaty, business profits of an enterprise of one country are taxable in the other country only to the extent they are attributable to a permanent establishment in the other country through which the enterprise carries on business. This is one of the basic limitations on a source country's right to tax income of a nonresident.

The taxation of business profits under the proposed treaty differs from United States rules for taxing business profits primarily in requiring more than merely being engaged in trade or business before a country can tax business profits. Under the Internal Revenue Code, all that is necessary for effectively connected business profits to be taxed is that a trade or business be carried on in the United States. Under the proposed treaty, on the other hand, some level of fixed place of business must be present.

"Profits" is defined to mean income derived by any person from carrying on a trade or business, including the rental of tangible personal (movable) property. The amount of profits attributable to a permanent establishment must be determined by the same method each year unless there is good and sufficient reason to change the method.

The business profits of a permanent establishment are determined on an arm's-length basis. Thus, there is to be attributed to it the business profits which would reasonably be expected to have been derived by it if it were an independent entity engaged in the same or similar activities under the same or similar conditions and dealing at arm's length with the resident enterprise of which it is a permanent establishment. Amounts may be attributed whether they are from sources within or without the country in which the permanent establishment is located.

In computing taxable business profits, deductions are allowed for expenses, wherever incurred, which are incurred for purposes of the permanent establishment. These deductions include a reasonable allocation of executive and general administrative expenses, interest, research and development, and other expenses which are incurred for purposes of the enterprise as a whole (or for purposes of that part of the enterprise which includes the permanent establishment). Thus, for example, a U.S. company which has a branch office in Malta but which has its head office in the United States will, in computing the Maltese tax liability of the branch, be entitled to deduct a portion of the executive and general administrative expenses incurred in the United States by the head office for purposes of administering the Maltese branch.

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

Where profits include items of income which are dealt with separately in other articles of the treaty, those other articles, and not the business profits article, will govern the treatment of those items of income. Thus, for example, film rentals are taxed under the provisions of Article 12 (Royalties), and not as business profits.

The provisions of this article will not affect the taxation of insurance companies. Thus, each country will continue to tax insurance companies under its tax law without reference to this article. The United States will be able to impose the excise tax on insurance premiums paid to foreign insurers under section 4371, on premiums paid to a Maltese insurance company, and Malta would grant a credit for this tax.

Article 8. Shipping and Air Transport

The proposed treaty provides that income which is derived by an enterprise of one country from the operation of ships and aircraft in international traffic shall be exempt from tax by the other country. International traffic means any transportation by ship or aircraft, except where the transportation is solely between places in the other country (Article 3(1)(d) (Definitions)). The exemption applies even if the ship or aircraft is not registered in either country. Thus, income of a U.S. resident from the operation of a ship flying, for example, the Liberian flag would not be subject to Maltese tax. The exemption also applies to income from participation in a pool, a joint business or an international operating agency which is engaged in the operation of ships and aircraft in international traffic.

The exemption for shipping and air transport profits applies to profits from the rental on a full or bare boat basis of ships or aircraft which are operated in international traffic by the lesee, or if the rental profits are incidental to the actual operation of ships and aircraft in international traffic. (Rental on a full or bare boat basis refers to whether the ships or aircraft are leased fully equipped, manned and supplied or not.) Income from the operation in international traffic of ships or aircraft also includes income derived from the use, maintenance, or rental of containers, trailers for the inland transportation of containers, and other related equipment where the equipment is used in the international transport of goods and merchandise.

This article also contains a provision to prevent "treaty shopping" with respect to ships. (See discussion of treaty shoping under explanation of Article 16.)

The treaty provides that if a corporation resident in Malta has more than 25 percent of its voting stock owned, either directly or indirectly, by persons not resident in Malta, then the provisions of this article will not apply and income from theoperation and sale of ships engaged in international traffic may be taxed by the United States. However, this provision will not apply, notwithstanding ownership of the Maltese shipping company by foreign persons, if the corporation can prove that the income from the operation of the ship is subject to Maltese tax. Under the Malta Merchant Shipping Act of 1973, certain vessels registered in Malta are exempt from tax by Malta. Nonresidents of Malta may establish a Maltese corporation to operate ships without incurring tax by Malta.

The Exchange of Notes with respect to this treaty makes clear that if a corporation resident in Malta is subject to the treaty shopping rules the income from the operation of the ship will be considered to be business profits. Accordingly, the United States would tax the profits of that corporation but only to the extent they are attributable to a permanent establishment the Maltese corporation has in the United States.

Article 9. Associated Enterprises

The proposed treaty, like most other U.S. tax treaties, contains a provision similar to section 482 of the Internal Revenue Code which recognizes the right of each country to make an allocation of income to that country in the case of transactions between related enterprises, if an allocation is necessary to reflect the conditions and arrangements which would have been made between independent enterprises. When a redetermination has been made by one country, the other country, if it agrees with the adjustment, will make an appropriate adjustment to the amount of tax paid in that country on the redetermined income. In making that adjustment due regard is to be given to other provisions of the treaty and the competent authorities of the two countries will consult with each other if necessary.

For purposes of the proposed treaty an enterprise in one country is not independent with respect to an enterprise in another country if one of the enterprises participates directly or indirectly in the management, control or capital of the other enterprise. The enterprises are also not independent if the same persons participate directly or indirectly in the management, control, or capital of both enterprises.

The provisions of the proposed treaty are not intended to limit any law in either country which permits the distribution, apportionment, or allocation of income, deductions, credits or allowances between non-independent persons when such law is necessary to prevent evasion of taxes or to reflect clearly the income of those persons. This provision makes clear that the United States retains the right to apply its intercompany pricing rules (section 482) and its rules relating to the allocation of deductions (sections 861, 862, and 863, and Treas. Reg. Section 1, 861–8).

Article 10. Dividends

The United States imposes a 30-percent tax on the gross amount of U.S. source dividends paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. The treaty reduces this tax, and also Maltese tax on dividend income. U.S. source dividends are dividends paid by a U.S. corporation, and dividends paid by a foreign corporation if at least 50 percent of the gross income of the corporation, in the prior three year period, was effectively connected with a U.S. trade or business of that foreign corporation.

Under the proposed treaty, each country may tax dividends paid by its companies to shareholders resident in the other country (i.e., they may impose a dividend withholding tax on shareholders resident in the other country). In the case of the United States, the rate of tax may not exceed 15 percent if the beneficial owner is a resident of Malta. The U.S. withholding tax rate is limited to 5 percent in the case of dividends paid to a company which directly or indirectly owns at least 10 percent of the voting stock of the company making the dividend distribution.

In the case of Malta, the tax cannot exceed the amount chargeable to the company paying the dividend in the year the distribution was made. This provision reflects Malta's integrated corporate tax system. Under Maltese law, a Maltese corporation pays a tax of 32.5 percent. When the corporation pays a dividend, the shareholder who receives the dividend must "gross-up" the dividend by the amount of tax paid at the corporate level on the distributed income. He is then taxed on the grossed up amount but gets a credit for the tax paid by the corporation. Under Maltese law, U.S. shareholders will get this credit.

What this means is that a U.S. corporate shareholder of a Maltese company that is subject to tax on the dividend will pay no Maltese tax. A U.S. resident individual would also be taxed by Malta at the statutory rate. Maltese tax rates range up to 65 percent. If the rate on his income is above 32.5 percent he will be able to credit the corporate tax against his Maltese liability on that income. If a U.S. individual is subject to Maltese tax at a rate below 32.5 percent, he can receive a refund from Malta.

The proposed treaty defines dividends as income from shares or other rights which participate in profits and which are not debt claims. Dividends also include income from other corporate rights which are taxed by the country in which the distributing corporation is resident in the same manner as income from shares.

Each country may tax dividends paid by companies of the other country but only insofar as (a) the dividends are paid to residents of the country imposing the tax, (b) the dividends are effectively connected with a permanent establishment or a fixed base in the taxing country, or (c) at least 50 percent of the paying company's gross income is attributable to profits of a permanent establishment in the taxing country. In this last situation, however, the tax can be imposed only to the extent the dividends are paid out of the profits derived from the permanent establishment and, in addition, the rate of tax on the taxable portion is limited to the withholding rules (described above) applicable to dividends paid by companies of the taxing country. This third provision permits the United States to continue to tax dividends paid by foreign corporations doing substantial business in the U.S. The provision is, however, somewhat different than U.S. rules because the 50 percent of gross income test in the treaty is based on the total profits from which the dividends are paid, while under U.S. rules, dividends are taxable if the three-year rule is met. Also, the income test compares profits to gross income. In addition, the permanent establishment concept may be somewhat more limited than the U.S. trade or business concept. (See discussion in Article 7. Business Profits.)

This last limitation does not apply to Malta because Malta does not tax dividends paid by foreign corporations regardless of the extent to which the dividends were derived from Maltese source profits of the distributing foreign corporation.

The reduced rates of tax on dividends will apply unless the recipient has a permanent establishment (or fixed base in the case of an individual performing independent personal services) in the source country and stock on which the dividends are paid is effectively connected with the permanent establishment (or fixed base). Dividends effectively connected with a permanent establishment are to be taxed as business profits (Article 7). Dividends effectively connected with a fixed base are to be taxed as income from the performance of independent personal services (Article 14).

Article 11. Interest

The United States imposes a 30-percent tax on U.S. source interest paid to foreign persons under the same rules that are applicable to dividends. U.S. source interest generally is interest on debt obligations of U.S. persons, but not interest on deposits in banks. U.S. source interest also includes interest paid by a foreign corporation if at least 50 percent of the gross income of the foreign corporation, in the prior three-year period was effectively connected with a U.S. trade or business of that corporation.

Under the proposed treaty, interest may be taxed by a country only if the recipient is a resident of that country, the interest arose in that country, or the debt claim to which the interest relates is effectively connected with a permanent establishment or fixed base in that country. The proposed treaty limits the withholding tax to 12½ percent generally and exempts interest payments to exempt governmental organizations of the other country.

Under the Exchange of Notes, Malta will impose a provisional withholding tax on gross interest income arising in Malta but will tax the interest to the recipient at the normal Maltese rates as part of the recipient's total Maltese income subject to Maltese tax. Malta will allow deductions that are attributable to the interest so that the interest will be taxed on a net basis. However, the amount of the tax so imposed may not exceed 12½ percent of the gross interest. The effect is that a U.S. lender can choose the lower tax burden—either gross or net.

The reduction in the withholding tax will not apply if the recipient has a permanent establishment or fixed base in the source country and the debt on which the interest is paid is effectively connected with the permanent establishment or fixed base. In that event, the interest will be taxed as business profits (Article 7) or income from the performance of independent personal services (Article 14).

The proposed treaty defines interest as income from debt claims of every kind, whether or not secured and whether or not carrying a right to participate in profits. In particular, it includes income from government securities and from bonds or debentures, including premiums or prizes attaching to bonds or debentures. It is understood that this provision permits the United States to apply its rules for distinguishing between debt and equity (sec. 385) with the competent authorities settling disputes if conflicts between U.S. and Maltese rules cause double taxation.

The proposed treaty provides a source rule for interest (which is also used in Article 21 (Relief from Double Taxation), for foreign tax credit purposes. Interest will be sourced within a country if the payor is the government of that country, including political subdivisions and local authorities, or a resident of that country. Generally, this is consistent with U.S. source rules (sections 861–862) which say that interest income is sourced in the country in which the payor is resident. However, if the interest is borne by a permanent establishment (or fixed base) that the payor has in one of the countries and the indebtedness was incurred with respect to that permanent establishment (or fixed base), the interest will be sourced in that country, regardless of the residency of the payor.

The proposed treaty also addresses the issue of non-arm's-length interest charges between related parties (or parties having an otherwise special relationship) by holding that the amount of interest for purposes of the treaty will be the amount of arm's-length interest. The amount of interest in excess of the arm's length interest will be taxable according to the laws of each country, taking into account the other provisions of this treaty (e.g., excess interest paid to parent corporation may be treated as a dividend under local law and thus entitled to the benefits of Article 10 of this treaty).

Article 12. Royalties

Under the same system that applies to dividends and interest, the United States imposes a 30-percent tax on all U.S. source royalties paid to foreign persons. Royalties are from U.S. sources if they are from property located in the United States including royalties for the use of or the right to use intangibles in the United States.

The proposed treaty provides for reduction of source basis taxation, but differs from the U.S. and OECD models by providing separate rules for taxation at source of industrial royalties and cultural royalties. Cultural royalties are exempt from tax by the county of source while industrial royalties are not.

Industrial royalties that arise (see royalty source ruled discussed below) in one country and are paid to a resident of the other country may be taxed by both countries. However, the withholding tax imposed by the source country may not exceed 12½ percent on the gross royalty. The exchange of notes with the proposed treaty makes clear that the system for taxing individual royalties is the same as that for interest. Royalties will be taxed by Malta on a net basis, but not in excess of 12½ percent of the gross amount of the royalty.

Industrial royalties are payments for the use of, or the right to use, cinematographic films, tapes for television or broadcasting, patents, designs, models, plans, secret processes or formulae trademarks or other similar property or rights. They also include payments for scientific technical, industrial or commercial knowledge or information ("know-how") held by the person supplying the know-how, including ancillary and subsidiary assistance with respect to the know-how. Finally, gains from the sale or other disposition of these properties or rights will be considered to be industrial royalties, to the extent that the payment of the sale price is contingent on the productiviy, use or alienation of the property.

The proposed treaty provides that cultural royalties will only be taxed in the recipient's country of residence (i.e., no withholding tax will be imposed on cultural royalties). Cultural royalties are defined as payments for the use of, or the right to use, copyrights of literary, artistic, and scientific works, but not cinematographic films or tapes for television or broadcasting which are treated as industrial royalties. As in the case of industrial royalties, cultural royalties also include gains from the sale or other disposition of these works, to the extent that the payment of the sale price is contingent on the productivity, use or alienation of the property.

The reduced withholding tax rate or exemption does not apply where the recipient is an enterprise with a permanent establishment in the source country or an individual performing personal services in an independent capacity through a fixed base in the source country, and the royalties are effectively connected with the permanent establishment or fixed base. In that event the royalties will be taxed as business profits (Article 7) or income from the performance of independent personal services (Article 14).

The proposed treaty provides special source rules for royalties. Generally, under U.S. tax rules (section 861–862) royalty income is sourced where the property or right is being used. The general rule in the proposed treaty is the same as the U.S. Code rule, that is, if the property or rights which are the subject of the royalty are used in one of the countries then the royalty is sourced in that country. However, if a royalty is paid by the government of one of the countries, including political subdivisions and local authorities, or by a resident of that country, and if the property is used in a third country then the income will be sourced in the country of residence of the payor.

The proposed treaty provides that in the case of royalty payments between related parties or persons otherwise having a special relationship, only that portion of the payment that represents an arm's-length royalty will be treated as a royalty under the treaty. Payments in excess of the arm's-length amount will be taxable according to the law of each country with due regard being given for the other provisions of the treaty. Thus, for example, any excess amount might be treated as a dividend subject to the taxing limitations of Article 10.

Article 13. Capital Gains

Under the Code, capital gains derived from U.S. sources by foreign investors are generally exempt from U.S. tax. Gains from the disposition of U.S. real property and U.S. real property interests are taxed. (See discussion of Article 7.) The proposed treaty generally provides that capital gains derived by a resident of one country will be exempt from tax by the source country.

The treaty exemption does not apply in two situations, and in those situations the gains may be taxed by both countries (with relief from double taxation provided pursuant to Article 24). First, gains from the sale or exchange of real property or stock of a company whose assets consist principally of real property located in one of the countries may be taxed in the country where the property is located (see discussion for Article 6). Second, gains from the sale or exchange of movable property which forms a part of the business property of a permanent establishment or a fixed base (including gains on the disposition of the permanent establishment or the fixed base itself) may be taxed in the country where the permanent establishment or fixed base is located. The second exception does not apply to gains from the sale or exchange of ships, aircraft or containers operated by an enterprise of the other country in international traffic; such gains are only taxable by the country of residence.

Gains from the disposition of cultural or industrial intangible property described in Article 12 (Royalties) will only be taxed in accordance with that article.

Article 14. Independent Personal Services

The income of a nonresident alien from the performance of personal services is not taxed if the individual is not in the United States for at least 90 days, the compensation does not exceed $3,000, and the services are performed as an employee of a foreign person not engaged in a trade or business in the United States or they are performed for a foreign permanent establishment of a U.S. person. The United States taxes the income of a nonresident alien at regular rates if the income is effectively connected with the conduct of a trade or business in the United States by the individual. (See discussion of U.S. taxation of business profits under Article 7 (Business Profits)). The performance of personal services within the United States can be a trade or business within the United States (section 864(b)).

The proposed treaty limits the right of a country to tax income from the performance of personal services by a resident of the other country. Under the proposed treaty, income from the performance of independent personal services is treated separately from income from the performance of dependent personal services.

Income from the performance of independent personal services (i.e., services performed as an independent contractor, not as an employee) in one country by a resident of the other country is exempt from tax in the country where the services are performed unless (1) the person performing the personal service is present in the country where the services are performed for 90 or more days during the taxable year, or (2) the individual has a fixed base regularly available to him in that country for the purpose of performing the services, or (3) the compensation is paid by residents of the country where the services are performed and the amount of the compensation exceeds $10,000 U.S. dollars or its equivalent for the taxable year. In the second situation, the source country can only tax that portion of the individual's income which is attributable to the fixed base.

Independent personal services include independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists, and accountants. The 90-day threshold period for asserting jurisdiction to tax is shorter than that in the U.S. model (which is 183 days), and the dollar threshold is not in the U.S. model. These provisions recognize Malta's status as a developing country.

Article 15. Dependent Personal Services

Under the proposed treaty, income from services performed as an employee in one country (the source country) by a resident of the other country will not be taxable in the source country if three requirements are met: (1) the individual is present in the source country for less than 183 days during the taxable year; (2) his employer is not a resident of the source country; and (3) the compensation is not borne by a permanent establishment or fixed base of the employer in the source country.

Compensation derived by an employee aboard a ship or aircraft operated by a resident of one country in international traffic is exempt from tax by the other country, provided that the compensation is in respect of employment as a member of the regular complement of the ship or aircraft.

This article is modified by the articles relating to director's fees (Article 17), pensions and annuities (Article 19) or to compensation as a government employee (Article 20).

Article 16. Investment or Holding Companies

The proposed treaty is intended to limit double taxation caused by the interaction of the tax systems of the United States and Malta as they apply to residents of the two countries. At times, however, residents of third countries attempt to use treaties by treaty shopping. Treaty shopping refers to the situation where a person who is not a resident of either country a party to a treaty seeks certain benefits under the income tax treaty between the two countries. Under certain circumstances, the nonresident is able to secure these benefits by establishing a corporation (or other entity) in one of the countries which, as a resident of that country, is entitled to the benefits under the treaty. Additionally, it may be possible for the third-country resident to repatriate funds to that third country from the entity under favorable conditions (i.e., it may be possible to reduce or eliminate taxes on the repatriation) either through relaxed tax provisions in the distributing country or by passing the funds through other treaty countries (essentially, continuing to treaty shop) until the funds can be repatriated under favorable terms.

The proposed treaty contains a provision which denies the benefits of the dividends, interest, and royalties articles to a corporation that is entitled in its country of residence to special tax benefits resulting in a substantially lower tax on those types of income than the tax generally imposed on corporate profits by that country. The provision only applies if more than 25 percent of the capital of the corporation is owned by nonresidents of that country. It is intended to have broad application. Accordingly, the term "capital" should be construed broadly. It would include, for example, common and preferred stock and convertible debt. It would also apply if nonresidents had effective control over the capital of the company. A similar provision is contained in several recent U.S. tax treaties.

If this holding company provision applies, the source country can impose its full statutory tax on dividends, income, or royalties paid to the company. Thus, the United States could tax that income at the 30-percent statutory rate.

The purpose of this provision is to prevent residents of third countries from using a corporation in one treaty country, which is preferentially taxed in that country, to obtain the tax benefits which the proposed treaty provides for dividends, interest, and royalties derived from the other country. At the present time, neither Malta nor the

United States grants to investment or holding companies the type of tax benefits with respect to dividends, interest, and royalties which would make this provision of the proposed treaty applicable. Thus, the provision will have effect only if Malta or the United States should subsequently enact special tax measures granting preferential tax treatment to dividends, interest, and royalties received by an investment or holding company.

For purposes of this article, the dividend, interest, and royalty source rules of Article 24 (Relief from Double Taxation) shall apply.

Article 17. Directors' Fees

This provision modifies Article 14 (Independent personal services) and Article 15 (Dependent personal services), and provides that if a resident of one country receives fees as a director of a company of the other country which are in excess of a reasonable amount paid to all directors for attendance at meetings in that other country, then the other country may tax that excess (even if the director is not physically present in the other country in connection with his duties as a director). Director's fees do not include fixed or contingent payments received by the person in his capacity as an officer or employee of the company. The U.S. model does not have a provision specifically covering directors fees, but developing countries generally want one.

Article 18. Entertainers and Athletes

The proposed treaty contains a separate set of rules which govern the taxation of income earned by public entertainers (such as theater, motion picture, radio or television artists and musicians) and athletes. The proposed article modifies the other provisions dealing with the taxation of personal services (Articles 14 and 15).

Under the Article, one country may tax an entertainer or athlete who is a resident of the other country on the income from his personal services performed in that country during any year in which he was present in that country for at least 90 days during the taxable year or the income received exceeded $500 for each day of performance including rehearsal, or exceeded $5,000 for the taxable year. As in the case of the other provisions dealing with personal services income, this provision does not bar the country of residence or citizenship from also taxing that income (subject to a foreign tax credit).

In addition, the proposed treaty provides that where income in respect of personal services performed by an entertainer or athlete is paid not to the entertainer or athlete but rather to another person or entity, that income will be taxable by the country in which the services are performed in any situation where the entertainer or athlete shares directly or indirectly in the profits of the person or entity receiving the income. (This provision applies notwithstanding Articles 7, 14, and 15.) For this purpose, participation in the profits of the recipient of the income includes the receipt of deferred compensation, bonuses, fees, dividends, partnership distributions, or other distributions. The provision does not apply if it is established that neither the entertainer or athlete, nor related persons, participate directly or indirectly in the profits of the person or entity receiving the income in any manner. This provision prevents highly paid performers and athletes from avoiding tax in the country in which they perform by routing the compensation for their services through a third person such as a personal holding company or trust located in a country that would not tax the income.

Article 19. Pensions and Annuities

Under the proposed treaty, private pensions (and other similar compensation for past services) beneficially derived by residents of either country are subject to tax only in the recipient's country of residence. This rule does not apply in the case of pensions which are paid to resident nationals of one country attributable to services performed by the individual for government entities of the other (Article 20(2) (Governmental Service)).

The proposed treaty also provides that annuities will only be taxed in the recipients' country of residence. Annuities are defined as a stated sum paid periodically at stated times during life or during a specified number of years, under an obligation to make the payments in return for adequate and full consideration (other than services renedered).

Article 20. Governmental Service

Under the proposed treaty, compensation paid by one country, its political subdivisions or local authorities, to an individual for labor or personal services performed for the paying governmental entity is taxable only by that country. However, this provision does not apply if the services are performed in the other country and the individual is a resident of that country and such resident is also a national of that country or did not become a resident of that country solely for the purpose of performing the service. In that situation, the compensation is only taxable by the country where the services are performed. Thus, an individual performing services for a Maltese government entity ordinarily will only be taxable by Malta. However, if he is a U.S. resident performing the services in the United States and is a U.S. citizen or his reasons for becoming a U.S. resident were not solely to work for that Maltese governmental agency, he will be taxable only by the United States.

A special rule is provided for a spouse or dependent child of an employee of one of the countries. If the government employee performs services for the government of one country in the other country, and qualifies for the exemption from tax in the other country, then that person's spouse or dependent child can subsequently perform services for the same government and the income from the services will not be subject to tax by the other country. Solely because the spouse or dependent child did not become a resident of the other country solely for the purpose of the government employment.

Pensions paid for services performed for a governmental entity of either country will generally only be taxable by that country. However, if the recipient is a resident national of the other country, the pension will only be taxable by that other country.

The governmental services rules do not apply in situations where the compensation or pensions are paid in connection with any business carried on by any governmental entity of either country. In such situations, the provisions applicable to the private sector apply; Article 14 (Independent Personal Services), 15 (Dependent Personal Services) and 18 (Entertainers and Athletes), and 19 (Pensions and Annuities).

Article 21. Teachers

The proposed treaty provides that if a teacher or professor who is a resident of one country teaches or engages in research in the other country, he will be exempt from tax by the host country on income from teaching or engaging in research if he is present in that country for a period not exceeding 2 years and his remuneration is paid to him from sources outside the host country. The requirement that the remuneration be paid from sources outside the host country is new to U.S. treaties. The exemption only applies if the individual comes to the other country primarily for the purpose of carrying out advanced study or research or for teaching at a university, college, school, or other educational institution. It is not to apply with respect to income from research which is undertaken primarily for the private benefit of a specific person or persons.

If the teacher or researcher remains in the other country for a period exceeding 2 years, the exemption will be lost retroactively. This retroactive loss of exemption is in the recent U.K. treaty but is otherwise unlike other U.S. treaties in that the other treaties exempt the income received for the first 2 years.

Article 22. Students and Trainees

Under the proposed treaty, a resident of one country who becomes a full-time student, apprentice, or business trainee in the other country will generally be exempt from tax in the host country on payments from abroad used for maintenance, education, or training.

A full-time student, apprentice or business trainee who qualifies for the exemption from tax by the host country may also elect under the treaty to be treated for tax purposes as a resident of the host country. The election applies for the entire taxable year of the election and all subsequent taxable years during which the individual is a full-time student, apprentice, or business trainee, and it may not be revoked except with the consent of the competent authority of the host country. The purpose of the election is to permit foreign students, apprentices, and business trainees present in the United States to qualify for benefits such as the zero bracket amount (standard deduction), and for the dependency deductions (if applicable). For example, for U.S. tax purposes nonresident aliens are limited to one personal deduction and they are not permitted to claim the standard deduction or the dependency deduction. By electing to be taxed as U.S. residents, they may claim these deductions but, as a consequence, they are subject to U.S. tax on their worldwide income. This election would generally be advantageous for those foreign students, apprentices, and business trainees who do not have any substantial income from sources without the United States.

Article 23. Other Income

Items of income not otherwise dealt with in the proposed treaty which are derived by residents of either country shall be taxable only by the country of residence, regardless of the source of the income. This rule applies to income from sources in a third country and to income from the source country not otherwise dealt with. It also applies even if the country of residence does not tax the income. The rule is subject to the saving clause.

That rule, however, will not apply to the income of residents of one country who carry on a business in the other country through a permanent establishment or who perform independent personal services in that other country from a fixed base situated therein, where the income paid is effectively connected with the permanent establishment or fixed base. In such situations the provisions of Articles 7 (Business Profits), 14 (Independent Personal Services), and 18 (Entertainers and Athletes) shall apply. However, it does not apply to income from immovable property.

Article 24. Relief from Double Taxation

Under the proposed treaty, each country agrees to allow a foreign tax credit for the appropriate amount of income taxes paid to the other country. The credit allowed for U.S. tax purposes is in accordance with the provisions and subject to the limitations of U.S. law applicable to the year in question.

The proposed treaty also provides that a deemed-paid foreign tax credit will be made available to a U.S. corporation with respect to dividends from a Maltese corporation in which it has at least a 10-percent ownership interest. In this case, a credit will be allowed for the Maltese tax paid by the Maltese corporation on the earnings out of which the dividend is paid. A deemed-paid foreign tax credit satisfying the treaty requirements is presently provided under the Internal Revenue Code. Similarly, the proposed treaty provides that Malta is to provide a deemed-paid foreign tax credit for U.S. tax attributable to dividends received by Maltese corporations from U.S. corporations in which they are 10-percent shareholders.

This article provides that all the Maltese taxes covered by the treaty (Article 2. Taxes Covered) are to be considered to be income taxes for purposes of the U.S. foreign tax credit. Accordingly, all the Maltese taxes covered by the treaty will be eligible for the U.S. foreign tax credit. These taxes would probably be creditable for U.S. tax purposes in the absence of the proposed treaty.

The proposed treaty provides that, for purposes of computing the credit under the treaty, with the exception of interest, royalties and dividends, income received by a resident of one country will be considered to be from sources in the other country if that other country may tax that income in accordance with the provisions of the treaty (other than merely pursuant to the saving clause). Interest and royalties will be sourced in the country provided for in Article 11(6) and Article 12(5), respectively. Dividends will be sourced in a country if it is paid by a resident of that country or if Article 10(5)(c) applies.

Article 25. Nondiscrimination

The proposed treaty contains a comprehensive nondiscrimination provision relating to all taxes of every kind imposed at the national, state, or local level. It is similar to provisions which have been embodied in other recent U.S. income tax treaties.

Under this provision, neither country can discriminate by imposing more burdensome taxes (or other requirements connected with taxes) on nationals of the other country than it imposes on its own nationals who are in the same circumstances. For this purpose, nationals taxable on their worldwide income are not to be considered to be in the same circumstances as nationals who are not. Thus, for example, the United States would not be required to tax a U.S. citizen and a Maltese citizen, neither of whom are residents of the United States in the same way because the U.S. citizen is taxed by the United States on his worldwide income while the Maltese citizen is not. This provision does not, however, require either country to grant to residents of the other country the personal allowances, reliefs, or deductions for taxation purposes on account of personal status or family responsibilities which it grants to its own residents.

Similarly, neither country may tax a permanent establishment of an enterprise of the other country less favorably than it taxes its own enterprises carrying on the same activities. In determining the taxable income of an enterprise of either country, both countries are required (except as provided in Article 9(1) (Associate Enterprises), 11(5) (Interest), and 12(4) (Royalties)) to allow the enterprise to deduct interest, royalties, and other disbursements paid by the enterprise to residents of the other country under the same conditions that they allow deductions for such amounts paid to residents of the same country as the enterprise. Similarly, for purposes of determining the taxable capital of an enterprise of one country, debts owed to residents of the other country are to be deductible under the same conditions as if they were owed to residents of the same country as the enterprise. The nondiscrimination provision also applies to corporations of one country which are owned by residents of the other country.

The provision is not intended to override the right of the United States to tax foreign corporations on their dispositions of a U.S. real property interest because the effect of the provisions imposing the tax is not discriminatory, nor is it intended to permit foreign corporations to claim the benefit of U.S. provisions intended to eliminate U.S. double tax, such as the dividends received exclusion provided by section 243.

Article 26. Mutual Agreement Procedure

The proposed treaty contains the standard mutual agreement provision which authorizes both the competent authority of the United States and Malta to consult together to attempt to alleviate individual cases of double taxation or cases of taxation not in accordance with the proposed treaty.

Under the proposed article a resident or citizen of one country who considers that the action of the countries or either of them will cause him to pay a tax not in accordance with the treaty may present his case to the competent authority of the country of which he is a resident or citizen. The competent authority then makes a determination as to whether or not the claim has merit. If it is determined that the claim does have merit, and if the competent authority cannot unilaterally solve the problem, that competent authority endeavors to come to an agreement with the competent authority of the other country to limit the taxation which is not in accordance with the provisions of the treaty.

A second provision directs the competent authorities to resolve any difficulties or doubts arising as to the application of the convention. Specifically, they are authorized to agree as to the attribution of profits to a resident of one country and its permanent establishment in another country, the allocation of income deductions or credits and the readjustment of taxes, the determination as to source of income, the characterization of items of income, and to the common meaning of terms. Under this authority, the Internal Revenue Service from time to time issues rulings defining terms in a treaty. The proposed treaty contains a provision, not found in most treaties, that permits the competent authorities to agree to increase dollar amounts reflected in the treaty to reflect monetary or economic developments.

The treaty authorizes the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of the mutual agreement provision. It also authorizes them to meet together for an oral exchange of opinions. These provisions make clear that it is not necessary to go through normal diplomatic channels in order to discuss problems arising in the application of the treaty and also removes any doubt as to restrictions that might otherwise arise by reason of the confidentiality rules of the United States or Malta.

Finally, the provision provides for the waiver of the statute of limitations of either country so as to permit the issuance of a refund or credit notwithstanding the statute of limitation. The provision, however, does not authorize the imposition of additional taxes after the statute of limitations has run.

Article 27. Exchange of Information

This article forms the basis for cooperation between the two countries to attempt to deal with avoidance or evasion of their respective taxes and to enable them to obtain information so that they can properly administer the treaty. The proposed treaty provides for the exchange of information which is necessary to carry out the provisions of the proposed treaty or for the prevention of fraud or for the administration of statutory provisions concerning taxes to which the convention applies. The exchange of information is specifically not limited by the personal scope article. Thus, information can be exchanged with respect to persons not covered by the proposed treaty such as persons not resident in either country.

The information exchanged may relate to tax compliance generally and not merely to avoidance or evasion of tax.

Information exchanged is to be treated as secret in the same manner as information obtained under the domestic laws of the receiving country, except that it may be disclosed to persons involved in the assessment or collection, or litigation concerning, the taxes to which the treaty applies. The information may be used for such purposes only. Accordingly, it is not clear that Congress in the exercise of its oversight responsibilities, couuld obtain the information. A country receiving a request will endeavor to obtain the information requested in the same way as if its own taxation was involved, notwithstanding the fact that the requested country does not, at that time, need the information. A requested country will use its subpoena or summons powers and any other powers that it has under its own laws to collect information requested by the other country, even though it itself does not need that information for its own purposes. It is intended that the requested country will use those powers even if the requesting country could not under its own laws. Thus, it is not intended that provision be strictly reciprocal. For example, once the U.S. Internal Revenue Service has referred a case to the Justice Department for possible crimiual prosecution, the United States investigators can no longer use an administrative summons to obtain information. If, however, Malta could still use administrative process to obtain requested information, it would be expected to do so even though the U.S. cannot. The U.S. could not, however, tell Malta which of its procedures to use.

The requested competent authority will attempt to provide the information requested in the form requested. Specifically, the competent authority will attempt to provide dispositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts or writings) to the extent that they can be obtained under the laws and practices of the requested country in the enforcement of its own tax laws.

A country is not required to carry out administrative measures contrary to its laws or administrative practice, to supply information not obtainable under its laws or in the normal course of administration, or to supply information that would disclose a trade secret or the disclosure of which would be contrary to public policy.

Article 28. Diplomatic Agents and Consular Officials

The proposed treaty contains the rule found in other U.S. tax treaties that its provisions are not to affect the taxation privileges of diplomatic agents or consular officials under the general rules of international law or the provisions of special agreements.

Article 29. Entry into Force

The proposed treaty is subject to ratificataion in accordance with the applicable procedures of each country and the instruments of ratification will be exchanged as soon as possible at a location to be announced. The treaty will enter into force when the instruments of ratification are exchanged. The treaty will become effective for taxable years beginning on or after January 1 of the year in which the proposed treaty comes into force.

Article 30. Termination

The proposed treaty will continue in force indefinitely, but either country may terminate it at any time after 3 years from its entry into force by giving at least 6 months' prior notice through diplomatic channels. If terminated, the termination will be effective with respect to income of taxable years beginning on or after January 1 next following the expiration of the 6-month period.

Exchange of Notes

At the signing of the convention notes were exchanged dealing with three issues.

First, the United States recognized that Malta emphasized the importance of provisions in a treaty that will create incentives to promote investment in Malta. The United States indicated that it could not accept these provisions but assured Malta that if circumstances changed the United States would reopen discussions with a view toward adopting provisions to promote investment in Malta. This provision is similar to that adopted with respect to all developing countries and reflects the desire of developing countries to have the United States adopt a "tax sparing" credit. Many developing countries provide tax holidays to residents of other countries who invest in the developing country. Generally they will forego tax on the profits from that business for a period of time. The U.S. would tax repatriations of the income of that business, in the view of some conflicting with the investment policy of the host country. Many developed countries solve this problem by giving a credit against their income tax imposed on the dividend distributions from the developing country corporation in an amount equal to the tax that would have been imposed on the income from which the dividend was paid. The U.S. has refused to do this.

Second, the shipping article (Article 8) is clarified to make clear that in cases covered by the treaty shipping provision of the shipping article the United States would be able to tax the shipping income of the Malta corporation only to the extent that the income is attributable to a permanent establishment of the Malta corporation in the United States.

Third, the note makes clear that the effective Malta tax on a U.S. resident who receives interest or royalties from Malta may be below the 12.5 percent maximum rate specified in the treaty. This is because Malta will tax that income at a net basis (after allowance of expenses) at ordinary rates. Malta's rates are 32.5 percent for corporate income and up to 65 percent for individuals. The interest and royalty articles limit the tax to 12.5 percent of the gross income, but in those cases in which the Maltese net income tax is less than 12.5 percent of gross income a refund of the appropriate part of the tax withheld will be made.

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