

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

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INTRODUCTION

This pamphlet,¹ prepared by the staff of the Joint Committee on Taxation, describes the proposed treaty and protocols between the United States and Bulgaria. The proposed treaty was signed on February 23, 2007, and the two proposed protocols were signed on February 23, 2007, and February 26, 2008, respectively. The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed treaty and protocols for July 10, 2008.²

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

¹ This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and Bulgaria* (JCX-59-08), July 8, 2008. References to “the Code” are to the U.S. Internal Revenue Code of 1986, as amended. This document is available on the internet at www.jct.gov.

² For a copy of the proposed treaty and protocols, *see* Senate Treaty Doc. 110-18.

I. SUMMARY

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

As in other U.S. tax treaties, these objectives principally are achieved through each country's agreement to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other country. For example, the proposed treaty contains provisions under which each country generally agrees not to tax business income derived from sources within that country by residents of the other country unless the business activities in the taxing country are substantial enough to constitute a permanent establishment (Article 5). The proposed treaty includes a special rule under which services performed by an enterprise of a treaty country in the other treaty country may give rise to a permanent establishment in the other country if the enterprise's activities in the other country occur for a certain number of days and if certain other conditions are met. The special rule applies if the enterprise does not have a permanent establishment in the other country by virtue of any of the customary treaty standards.

The proposed treaty provides that dividends, interest, royalties, and certain capital gains derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles 10, 11, 12, and 13); however, the rate of tax that the source country may impose on a resident of the other country on dividends, interest, and royalties may be limited by the proposed treaty (Articles 10, 11, and 12). Under the proposed 2007 protocol, the treaty countries agree to reconsider source-country taxation of interest and royalties arising in Bulgaria and beneficially owned by a resident of the United States, at an appropriate time that is consistent with the December 31, 2014 conclusion of Bulgaria's transition period under a European Union Council Directive applicable to interest and royalties deemed to arise in Bulgaria and beneficially owned by a resident of the European Union.

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

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

The proposed treaty provides authority for the two countries to exchange information (Article 25) in order to carry out the provisions of the proposed treaty. The proposed treaty also

contains a detailed limitation-on-benefits provision to prevent the inappropriate use of the treaty by third-country residents (Article 21).

The United States and Bulgaria do not have an income tax treaty currently in force. The rules of the proposed treaty and protocols generally are similar to rules of recent U.S. income tax treaties, the United States Model Income Tax Convention of November 15, 2006 (“U.S. Model”), the 2005 Model Convention on Income and on Capital of the Organisation for Economic Cooperation and Development (“OECD Model”), and the 1980 United Nations Model Double Taxation Convention Between Developed and Developing Countries, as amended January 11, 2001 (“U.N. Model”). However, the proposed treaty, as amended by the proposed protocols, contains certain substantive deviations from these treaties and models. These deviations are noted throughout the explanation of the proposed treaty and protocols in Part V of this pamphlet.

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

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

A. U.S. Tax Rules

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

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

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

Specific statutory exemptions from the 30-percent withholding tax are provided. For example, certain original issue discount and certain interest on deposits with banks or savings institutions are exempt from the 30-percent withholding tax. An exemption also is provided for certain interest paid on portfolio debt obligations. In addition, income of a foreign government or international organization from investments in U.S. securities is exempt from U.S. tax.

U.S.-source capital gains of a nonresident alien individual or a foreign corporation that are not effectively connected with a U.S. trade or business generally are exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien individual who is present in the

United States for at least 183 days during the taxable year, and (2) certain gains from the disposition of interests in U.S. real property.

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

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

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

B. U.S. Tax Treaties

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. Another related objective of U.S. tax treaties is the removal of the barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal. To a large extent, the treaty provisions designed to carry out these objectives supplement U.S. tax law provisions having the same objectives; treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty partner.

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

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

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

The objective of preventing tax avoidance and evasion generally is accomplished in treaties by the agreement of each country to exchange tax-related information. Treaties generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out provisions of the treaty or of their domestic tax

laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information that is not obtainable under its laws or in the normal course of its administration or that would reveal trade secrets or other information the disclosure of which would be contrary to public policy. The Internal Revenue Service (the “IRS”), and the treaty partner’s tax authorities, also can request specific tax information from a treaty partner. This can include information to be used in a criminal investigation or prosecution.

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

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

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

III. OVERVIEW OF TAXATION IN BULGARIA³

A. National Income Taxes

Overview

Bulgaria imposes income tax on net income at the national level. Taxable income is computed on an annual basis and is taxed either by assessment or by a final withholding tax. Individuals in Bulgaria generally are subject to a flat tax of 10 percent on income. Bulgaria's corporate income tax includes many features of a classical corporate tax system. Dividends from corporations received by corporate shareholders generally are tax exempt. Employers must contribute to the social security system, and a value-added tax, or VAT, is in place.

Individuals

Individuals resident in Bulgaria are taxed on their worldwide income. Sources of taxable income include employment income, business and professional income, investment income (e.g., dividends, interest, and royalties), and capital gains.⁴ Employment income is income earned under an employment contract and includes, for example, salary, bonuses, and benefits-in-kind. Tax on employment income is withheld by the employer on a monthly basis, and persons whose only income is from wages paid by a Bulgarian employer are not required to file annual tax returns.⁵ Business and professional income is computed on an annual basis. Business and professional income includes, among other things, income from activity as a sole trader, directors' fees, professional services income, and agricultural and forestry income.⁶ Bulgarian-source dividends received by residents are subject to a five-percent final withholding tax.⁷ In general, interest paid to resident individuals is not subject to withholding tax.⁸ Royalty payments are aggregated with the total taxable income and are entitled to a 40-percent deduction; royalty payments made to a resident individual are subject to an advance withholding tax of 15 percent.⁹

³ The information in this section relates to foreign law and is based on the Joint Committee staff's review of publicly available secondary sources, including in large part Dobrinka Shishkova et al., *IBFD European Taxation, Bulgaria*, available at <http://checkpoint.riag.com> (last accessed April 23, 2008). The description is intended to serve as a general overview; it may not be fully accurate in all respects, as many details have been omitted and simplifying generalizations made for ease of exposition.

⁴ IBFD Bulgaria Country Analysis B.1.2.

⁵ IBFD Bulgaria Country Analysis B.2.1.

⁶ IBFD Bulgaria Country Analysis B.2.3.

⁷ Lubka Tzenova, *Bulgaria, Tax Notes Int'l*, January 21, 2008, at 226; Lubka Tzenova, *2007 Year in Review (Bulgaria), Tax Notes Int'l*, December 31, 2007, at 1321.

⁸ IBFD Bulgaria Country Analysis B.2.4.

⁹ IBFD Bulgaria Country Analysis B.6.2.3.

A 10-percent deduction is allowed against capital gains, which are generally aggregated with the total taxable income. Certain categories of income are tax exempt, including bank deposit interest, winnings from gambling, income from specific real estate and securities transactions, scholarships, pensions from statutory social security funds, alimony, and certain insurance proceeds.¹⁰

Beginning January 1, 2008, the income of individuals is taxed at a flat rate of 10 percent.¹¹ Disabled individuals are entitled to BGN 7,920 (\$5,947)¹² allowance. A final flat tax of 15 percent applies to the net income of sole proprietors.

Corporations

Corporations resident in Bulgaria are subject to corporate tax on their worldwide income.¹³ A corporation is a resident of Bulgaria if it is registered under Bulgarian law. Other resident entities subject to the corporate tax include partnerships, limited liability companies, joint stock companies, nonprofit organizations, state-financed legal entities, and branches and permanent establishments of nonresident entities.

The standard corporate tax rate is 10 percent; however, this rate may be reduced or eliminated through a variety of tax incentives applicable to investment in regions with high unemployment.¹⁴ Companies operating exclusively in regions with high unemployment may be fully exempt from corporate income tax.¹⁵ Specific tax regimes apply to gambling and commercial marine shipping. Licensed investment companies are exempt from corporate income tax. Capital gains derived by resident entities are generally aggregated with all other income for taxation at the corporate rate; however, gains on shares listed on the Bulgarian Stock Exchange may be tax exempt. Capital losses and ordinary losses are indistinguishable under Bulgarian law and can be carried forward five years.¹⁶ Foreign, non-European-Union source tax losses may be deducted only from the same source income.

¹⁰ Personal Income Law of the Republic of Bulgaria, Derzhaven Vestnik [DV] No. 95, Nov. 24, 2006.

¹¹ Lubka Tzenova, 2007 Year in Review (Bulgaria), Tax Notes Int'l, December 31, 2007, at 1321.

¹² U.S. dollar equivalents were calculated using the exchange rate for January 1, 2008 according to OANDA's FX Converter, available at www.oanda.com.

¹³ IBFD Bulgaria Country Analysis A.2.5.

¹⁴ IBFD Bulgaria Country Analysis A.2.12.1.

¹⁵ *Id.* Corporate Income Tax Law of the Republic of Bulgaria, DV No. 105, Dec. 2, 2006.

¹⁶ IBFD Bulgaria Country Analysis A.2.11.

The taxation of dividends depends on the type of recipient. Dividends paid by a resident company to a resident corporate shareholder are tax exempt, regardless of the size of the shareholding, whereas dividends paid to a resident individual shareholder are taxed as previously described.¹⁷

¹⁷ IBFD Bulgaria Country Analysis A.7.1.2.

B. International Aspects of Taxation in Bulgaria

Individuals

Individuals resident in Bulgaria are taxed on their worldwide income.¹⁸ An individual is a resident of Bulgaria if he permanently resides in Bulgaria or spends 183 days in any 365-day period in Bulgaria. Nonresident individuals are taxed only on their Bulgarian-source income and capital gains.¹⁹ Bulgarian-source income includes income from businesses conducted in Bulgaria; income earned from employment and services performed in Bulgaria; dividends paid by Bulgarian entities; interest; royalties; income paid to directors of Bulgarian entities; rental income and capital gains from property located in Bulgaria; agricultural and forestry income; and payments under leasing, factoring, and franchising agreements. Bulgaria requires a withholding tax on dividends paid by resident companies to nonresident individuals at a rate of five percent.²⁰ Interest and royalty income arising from Bulgarian sources are subject to a withholding tax rate of 10 percent.²¹ A final tax of 10 percent must be paid by nonresident individuals on capital gains from the sale, exchange, or other transfer for consideration of immovable property or stocks, shares, and other financial assets, and from exchange of stocks and shares related to restructuring of companies.²² Nonresidents are treated the same as Bulgarian residents with respect to the taxation of all other capital gains (e.g., gains from moveable property).²³

Corporations

Companies resident in Bulgaria generally are taxed on their worldwide income. A foreign company is subject to the Bulgarian corporate tax on income derived through a permanent establishment in Bulgaria. A permanent establishment is any place of business through which the foreign company conducts, either wholly or partly, its business activities in Bulgaria. The activities of a nonresident's dependent agent also are deemed to constitute a permanent establishment, as is a place of continuous commercial activity.

In general, dividends paid by resident companies to nonresident corporate shareholders are subject to a final withholding tax at a rate of five percent. Certain qualifying Bulgarian-source income (for example, interest, royalties, technical services and management fees, rental payments, and capital gains from securities and real estate) paid to nonresident companies is

¹⁸ IBFD Bulgaria Country Analysis at B.14.1.1.

¹⁹ IBFD Bulgaria Country Analysis at B.14.3.1.

²⁰ IBFD Bulgaria Country Analysis at B.14.3.1.2 and Tax Notes updates.

²¹ IBFD Bulgaria Country Analysis at B.6.2.2 and B.6.2.3; B.14.3.1.2.

²² IBFD Bulgaria Country Analysis at B.14.3.1.4.

²³ IBFD Bulgaria Country Analysis at B.14.3.1.4 and B.2.4.

subject to a withholding tax rate of 10 percent. A 10-percent withholding tax also is imposed on capital gains derived by nonresident corporate shareholders.²⁴

Relief from double taxation

As of January 1, 2008, Bulgaria had concluded bilateral tax treaties with 62 countries.²⁵ The treaties' provisions supersede domestic laws. In the absence of a treaty, relief from double taxation of foreign source income is provided in the form of a tax credit. The tax credit is limited to the amount of the Bulgarian tax levied on the foreign-source income.

²⁴ IBFD Bulgaria Country Analysis A.7.1.6.2.

²⁵ IBFD Portal to Cross-Border Taxation Information.

C. Other Taxes

Inheritance, gift, and wealth taxes

Except for the surviving spouse and lineal heirs, individuals inheriting property located in Bulgaria are subject to an inheritance tax.²⁶ Bulgarian citizens are also subject to an inheritance tax on property located abroad. The inheritance tax is levied at a rate between 0.7 percent and 1.4 percent (depending on the municipality) for relatives in the lateral line and at a rate between five percent and 10 percent for all other beneficiaries.²⁷ The inheritance tax is calculated per beneficiary on the value of the inheritance at the time of death minus any debts of the deceased, such as funeral expenses. The first 250,000 BGN (\$187,707)²⁸ is tax free. Bulgaria also generally imposes a gift tax on property donated or transferred for no consideration. As with the inheritance tax, spouses and lineal heirs are exempt from the gift tax. A reduced rate of between 0.7 percent and 1.4 percent (depending on the municipality) applies to transfers between relatives in the lateral line.²⁹ All other beneficiaries are subject to gift tax at a rate between five percent and 10 percent. The gift tax is calculated on the basis of the market value of the donated property on the date of the acquisition. Bulgaria does not levy a wealth tax.³⁰

Social security

Social security contributions are levied on gross income, up to a maximum annual amount.³¹ Employee contributions are calculated at a total rate of 13 percent on income up to BGN 24,000 (\$18,020). Employers must contribute 19.5 percent for employees working under a contract (or higher rates for certain types of labor) plus an additional .9 to 1.6 percent. For self-employed individuals, the contribution amount varies depending on the individual's activity. Social security contributions are deductible for income tax purposes.

Other indirect taxes

Bulgaria imposes a value added tax (VAT) on the consumption of goods and services. The standard VAT rate is 20 percent, but the rate is reduced for certain products and services,³² and some products and services are exempt from VAT. Nonresident companies that make

²⁶ IBFD Bulgaria Country Analysis B.11.1.2.

²⁷ IBFD Bulgaria Country Analysis B.11.1.4.

²⁸ U.S. dollar equivalents were calculated using the exchange rate for January 1, 2008 according to OANDA's FX Converter, available at www.oanda.com.

²⁹ IBFD Bulgaria Country Analysis B.11.2.

³⁰ IBFD Bulgaria Country Analysis B.12.1.

³¹ IBFD Bulgaria Country Analysis A.4.2.

³² IBFD Bulgaria Country Analysis A.11.6.

taxable supplies in Bulgaria must also register for VAT purposes through an accredited representative. Owners of real property located in Bulgaria are subject to a real estate tax at a rate of 0.15 percent. If the property is the main residence of the taxpayer, a 50-percent discount is granted.³³ VAT incurred in Bulgaria by a person that is not VAT-registered or established in the country can be rebated.³⁴

Excise duties are charged on certain goods as a percentage of the sales price or customs value of those goods or as a flat amount per unit upon release of the goods for consumption.³⁵ For 2008, products subject to excise tax include cars, fuels, other energy products, electricity, tobacco products, and alcoholic beverages.

³³ IBFD Bulgaria Country Analysis B.12.2.

³⁴ VAT Act of the Republic of Bulgaria, DV No. 63, Aug. 4, 2006.

³⁵ Excise Duties and Tax Warehouse Act of the Republic of Bulgaria, DV No. 91, Nov. 15, 2005.

IV. THE UNITED STATES AND BULGARIA: CROSS-BORDER INVESTMENT AND TRADE

Introduction

A principal rationale for negotiating tax treaties is to improve the business climate for business persons in one country who might aspire to sell goods and services to customers in the other country and to improve the investment climate for investors in one country who might aspire to own assets in the other country. Clarifying the application of the two nations' income tax laws makes more certain the tax burden that will arise from different transactions, but may also increase or decrease that burden. Where there is, or where there is the potential to be, substantial cross-border trade or investment, changes in the tax structure applicable to the income from trade and investment has the potential to alter future flows of trade and investment. Therefore, in reviewing the proposed treaty it may be beneficial to examine the cross-border trade and investment between the United States and Bulgaria. Whether measured by trade in goods or services or by direct and non-direct cross-border investment, the United States and Bulgaria engage in modest cross-border activity at present. The income from cross-border trade and investment generally is subject to income tax in either the United States or Bulgaria and in many cases the income is subject both to gross basis withholding taxes in the source country and net basis income tax in the residence country.

A. Overview of International Transactions Between the United States and Bulgaria

Cross-border trade

The current account consists of three primary components: trade in goods; trade in services; and payment of income on assets invested abroad. While detail regarding the balance of payments between the United States and Bulgaria is not publicly available, one can document the value of trade between the United States and Bulgaria. In 2007, the United States exported \$306 million of goods to Bulgaria and imported \$426 million in goods from Bulgaria. This made Bulgaria the United States' 101st largest merchandise export destination and the 95th largest source of imported merchandise.³⁶

Cross-border investment

Income from foreign assets is categorized as income from “direct investments” and income from “non-direct investments.” Direct investment constitutes assets over which the owner has direct control. The Department of Commerce defines an investment as direct when a single person owns or controls, directly or indirectly, at least 10 percent of the voting securities of a corporate enterprise or the equivalent interest in an unincorporated business. Often the income that crosses borders from direct investments is in the form of dividends from a subsidiary to a parent corporation, although interest on loans between such related corporations is another source of income from a direct investment. In non-direct investments the investor generally does not have control over the assets that underlie the financial claims. Non-direct investments consist mostly of holdings of corporate equities and corporate and government bonds, generally referred to as “portfolio investments,” and bank deposits and loans. Hence, the income from non-direct investments generally is interest or dividends.

Commensurate with the size of the Bulgarian economy in comparison to other European countries, the value of cross-border investment, between the United States and Bulgaria is smaller than that of cross border investment between the United States and other European countries. In 2006, U.S. persons held direct investments in Bulgaria valued at \$18 million on a historic cost basis and Bulgarian persons held direct investments in the United States valued at \$1 million. The value of U.S. direct investment in Bulgaria has declined since 2003 when such investments were valued at \$186 million. Prior to 2006, Bulgarian direct investment in the United States on an historical cost basis at year-end was generally valued at less than \$500,000.³⁷ U.S. direct investments in Bulgaria produced approximately \$16 million in income to U.S.

³⁶ Bureau of Economic Analysis, U.S. Department of Commerce, “U.S. International Trade in Goods and Services, Annual Revision for 2007,” June 10, 2008.

³⁷ Jeffrey H. Lowe, “U.S. Direct Investment Abroad: Detail for Historical-Cost Position and Related Capital and Income Flows, 2004-2006,” *Survey of Current Business*, vol. 87, September 2007, and Jeffrey H. Lowe, “Foreign Direct Investment in the United States: Detail for Historical-Cost Position and Related Capital and Income Flows, 2004-2006,” *Survey of Current Business*, vol. 87, September 2007.

persons in 2006. Bulgarian direct investments in the United States produced negligible amounts of income or loss to Bulgarian persons in 2006.³⁸

The data presented above do not report the amount of U.S. or Bulgarian portfolio investments, holdings of stocks and bonds (including holdings of U.S. government securities). The Bureau of Economic Analysis generally only reports portfolio holdings by country for the several largest portfolio investment countries.

³⁸ *Id.* The Bureau of Economic Analysis reports income net of withholding taxes prior to 2006. Between 2002 and 2005 income to U.S. persons from direct investments in Bulgaria ranged from \$5 million to \$10 million annually net of withholding taxes. The Bureau of Economic Analysis reports nearly negligible income paid to owners of Bulgarian direct investments located in the United States, income or loss between -\$500,000 and \$500,000 annually for the period 2002-2006.

B. Analyzing the Economic Effects of Income Tax Treaties

Among other things, tax treaties often change both the amount and timing of income taxes and the country (source or residence) that has priority to impose such taxes. If the tax treaty changes increase the after-tax return to cross-border trade and investment, or to particular forms of trade or investment, in the long run there could be significant economic effects. Generally, to the extent a treaty reduces barriers to capital and labor mobility, more efficient use of resources will result and economic growth in both countries will be enhanced, although there may be negative transitional effects occurring in specific industries or geographic regions. On the other hand, tax treaties may also lead to tax base erosion if they create new opportunities for tax arbitrage. Tax treaties also often increase and improve information sharing between tax authorities. Improvements in information sharing and the limitation of benefits provision should reduce the potential for outright evasion of U.S. and Bulgarian income tax liabilities.

Generally, a treaty-based reduction in withholding rates will directly reduce U.S. tax collections in the near term on payments from the United States to foreign persons, but will increase U.S. tax collections on payments from foreign persons to the United States because of the reduction in foreign taxes that are potentially creditable against the U.S. income tax. To the extent that the withholding rate reduction encourages more income flows between the treaty parties, this dampening of collections on payments to foreign persons and related decrease in foreign tax credits will begin to reverse. The present treaty's reductions in dividend withholding rates will reduce U.S. withholding tax collections on dividend payments from the United States to Bulgaria. Over the longer term, the withholding tax rate changes coupled with other changes in the treaty are likely to cause small revenue increases in later years as capital flows increase and from improved allocation of capital.

However, this simple analysis is incomplete. A complete analysis of a withholding change, or any other change in a treaty, would account for both tax and non-tax related factors, such as portfolio capital needs in the affected countries, and the corresponding relation between current and financial accounts. The potential for future growth in each country is an important determinant of cross-border investment decisions. In sum, even in the short run, the larger macroeconomic outlook, compared to treaty modifications, is likely to be a more important determinant of future cross-border income and investment flows and the related tax collections.

V. EXPLANATION OF PROPOSED TREATY AND PROTOCOLS

Article 1. General Scope

In general

The general scope article describes the persons who may claim the benefits of the proposed treaty. It also includes a “saving clause” provision similar to provisions found in most U.S. income tax treaties, and a special rule for fiscally transparent entities similar to that found in the U.S. Model treaty.

Who may claim treaty benefits

Paragraph 1 provides that the proposed treaty generally applies only to residents of the United States and to residents of Bulgaria. The determination of whether a person is a resident of the United States or Bulgaria is made under Article 4 (Resident) of the treaty. Certain provisions are applicable to persons who may not be residents of either treaty country. For example, paragraph 1 of Article 23 (Non-Discrimination) applies to nationals of the treaty countries. Under Article 25 (Exchange of Information and Administrative Assistance), information may be exchanged with respect to residents of third states.

Relationship to U.S. law and other agreements

Paragraph 2 states the generally accepted relationship both between the treaty and domestic law and between the treaty and other agreements to which the United States and Bulgaria are parties. It provides that the treaty generally does not restrict any benefit accorded by internal law or by any other agreement between the United States and Bulgaria. This means that the proposed treaty will not apply to increase the tax burden of a resident of either the United States or Bulgaria beyond that determined under internal law.

Under the principles of paragraph 2, a taxpayer’s U.S. tax liability need not be determined under the proposed treaty if the Code would produce a more favorable result. The Technical Explanation states, however, that a taxpayer may not choose among the provisions of the Code and the proposed treaty in an inconsistent manner in order to minimize U.S. tax. The Technical Explanation includes an example illustrating this rule. In the example, a resident of Bulgaria has three separate businesses in the United States. One is a profitable permanent establishment and the other two are trades or businesses that would earn taxable income (or loss) under the Code but that do not meet the permanent establishment threshold tests of the proposed treaty. One is profitable and the other incurs a loss. Under the proposed treaty, the income of the permanent establishment is taxable in the United States, and both the income and loss of the other two businesses are ignored. Under the Code, all three would be subject to tax, but the loss would offset the income of the two profitable ventures. The Technical Explanation states that the taxpayer may not invoke the proposed treaty to exclude the income of the profitable trade or business and invoke the Code to claim the loss of the loss trade or business against the income of the permanent establishment. However, if the taxpayer invokes the Code for the taxation of all three ventures, he would not be precluded from invoking the proposed treaty with respect, for

example, to any dividend income he may receive from the United States that is not effectively connected with any of his business activities in the United States.

Paragraph 3 of the proposed treaty specifically relates to non-discrimination obligations of the treaty countries under the General Agreement on Trade in Services (the “GATS”). The provisions of paragraph 3 are an exception to the rule provided in paragraph 2 under which the proposed treaty may not restrict any benefit accorded by any other agreement between the United States and Bulgaria.

Paragraph 3 provides that, unless the competent authorities determine that a taxation measure is not within the scope of Article 23 (Non-Discrimination) of the proposed treaty, the national treatment obligations of the GATS shall not apply with respect to that measure. Further, for purposes of paragraph 3 of Article 22 (Consultation) of the GATS, any question arising as to the interpretation or application of the proposed treaty, including whether a taxation measure is within the scope of the proposed treaty, will be determined exclusively in accordance with the provisions of Article 24 (Mutual Agreement Procedure) of the proposed treaty. According to the Technical Explanation, the result under paragraph 3 of the proposed treaty is that paragraph 3 of Article 22 (Consultation) of the GATS may not be used to bring a dispute before the World Trade Organization unless the competent authorities of both treaty countries have determined that the relevant taxation measure is not within the scope of Article 23 (Non-Discrimination) of the proposed treaty.

Paragraph 3 provides that the term "taxation measure" means a law, regulation, rule, procedure, decision, administrative action, or any similar provision or action, relating to taxation.

Saving clause

Like all U.S. income tax treaties and the U.S. Model treaty, the proposed treaty includes a “saving clause” in paragraph 4. Under this clause, with specific exceptions described below, the proposed treaty does not affect the taxation by either treaty country of its residents or its citizens. By reason of this saving clause, subject to the exceptions described below, the United States may continue to tax its citizens who are residents of Bulgaria as if the treaty were not in force.

Subparagraph 4(b) generally also allows the United States to tax, in accordance with the laws of the United States, a former citizen or former long-term resident of the United States on such individual’s U.S.-source income (and deemed U.S.-source income) for a period of ten years following the loss of citizenship or long-term resident status.

Consistent with U.S. law, the 2007 proposed protocol provides that an individual is a “long-term resident” of the United States if the individual (other than a citizen of the United States) was a lawful permanent resident of the United States in at least eight of the 15 taxable years ending with the taxable year in which the individual ceased to be a long-term resident. It further provides that an individual is not treated as a lawful permanent resident for any taxable year in which the individual is treated as a resident of Bulgaria under the proposed treaty, or as a resident of any country other than the United States under the provisions of any other tax treaty of the United States, and, in either case, the individual does not waive the benefits of the relevant treaty.

Section 877 of the Code provides special rules for the imposition of tax on certain former U.S. citizens and long-term residents who relinquish their citizenship or cease to be a long-term resident prior to June 17, 2008. Under section 877, those individuals are subject to U.S. tax (for a period of 10 years) on both their U.S.-source income (including deemed U.S.-source income), and their foreign-source income that is effectively connected with the conduct of a trade or business within the United States.

Subparagraph 4(b) generally conforms to Code section 877, but it departs from the provision in one respect. While section 877 imposes U.S. tax on both U.S.-source income (including deemed U.S.-source income) and foreign source income effectively connected with the conduct of a trade or business within the United States, subparagraph 4(b) is limited to the taxation of U.S.-source income (and deemed U.S.-source income). Unlike the proposed protocol, the U.S. Model treaty follows Code section 877, providing for U.S. taxation of both U.S.-source income and effectively connected foreign-source income. As a practical matter, this difference may be of little significance in most cases.

For any individual who relinquishes U.S. citizenship or ceases to be a lawful permanent resident of the United States (“expatriates”) on or after June 17, 2008, the Heroes Earnings Assistance and Relief Tax Act of 2008,³⁹ replaces Code section 877 with a new set of special rules. In general, to the extent those rules impose U.S. tax on an individual after the individual expatriates, they require or deem the individual to waive any rights to claim a reduction in U.S. tax under a U.S. tax treaty and any other rights under a U.S. tax treaty that would preclude the assessment or collection of tax imposed by the new rules.

Paragraph 5 contains exceptions to the saving clause. Exceptions to the saving clause are provided for the following benefits conferred by the proposed treaty: the allowance of correlative adjustments when the profits of an associated enterprise are adjusted by the other country (Article 9, paragraph 2); social security and pension benefits (Article 17, paragraphs 2 and 5); relief from double taxation through the provision of a foreign tax credit (Article 22); protection from discriminatory tax treatment with respect to transactions with residents of the other country (Article 23); and benefits under the mutual agreement procedures of the treaty (Article 24).

In addition, the saving clause does not apply to certain benefits conferred by the United States or Bulgaria upon individuals who are neither citizens of, nor have been admitted for permanent residence in, the United States or Bulgaria, respectively. Under this set of exceptions to the saving clause, the specified treaty benefits are available to, for example, a citizen of Bulgaria who spends enough time in the United States to be taxed as a U.S. resident but who has not acquired U.S. permanent residence status (i.e., does not hold a “green card”). The benefits that are covered under this set of exceptions are exemptions from host country taxation for certain income for government service (Article 18), certain income received by students, trainees, teachers, and researchers (Article 19), and certain income received by members of diplomatic missions and consular posts (Article 26).

³⁹ Pub. L. No. 110-245, sec. 301 (June 17, 2008).

Fiscally transparent entities

Paragraph 6 sets forth a special rule for fiscally transparent entities (e.g., partnerships). Under this rule, income derived through an entity that is a fiscally transparent entity under the laws of either treaty country is considered to be the income of a resident of one of the treaty countries only to the extent that the income is treated, for purposes of that country's tax laws, as the income of a resident. As an example, the Technical Explanation states that if a corporation resident in Bulgaria pays interest to an entity that is treated as fiscally transparent for U.S. tax purposes, the interest will be considered derived by a resident of the United States only to the extent that U.S. tax laws treat one or more U.S. residents (whose status as U.S. residents is determined under U.S. tax laws) as deriving the interest for U.S. tax purposes.

The Technical Explanation states that the result in the above example would be the same if the entity were viewed differently under the laws of Bulgaria (i.e., as not fiscally transparent). The Technical Explanation also states that this result follows regardless of whether the entity is organized in the United States, Bulgaria, or a third country. Finally, the Technical Explanation states that these results follow regardless of whether the entity is disregarded as a separate entity under the laws of one jurisdiction but not the other, such as a single owner entity that is viewed as a branch for U.S. tax purposes and as a corporation for tax purposes of in Bulgaria.

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

However, paragraph 6 is not an exception to the saving clause in paragraph 4. Accordingly, paragraph 6 does not prevent a treaty country from taxing an entity that is treated as a resident of that treaty country under its tax laws. For example, if a U.S. corporation has Bulgarian shareholders, the United States will tax the corporation on its worldwide income on a net basis, without regard to whether Bulgaria views the corporation as fiscally transparent. Similarly, if an entity organized in Bulgaria and owned by U.S. residents is treated as a corporation under the tax laws of Bulgaria, Bulgaria may tax the entity on its worldwide income on a net basis, even if the United States views the entity as fiscally transparent.

Article 2. Taxes Covered

The proposed treaty applies to all taxes on income irrespective of the manner in which they are levied, including taxes on gains from the alienation of property, but excluding social security taxes. In the case of Bulgaria, the proposed treaty applies to the personal income tax and the corporate income tax (including the patent tax, as provided in the proposed 2007 protocol). In the case of the United States, the proposed treaty applies to the Federal income taxes imposed by the Code, excluding social security taxes, and to Federal taxes imposed on the investment income of foreign private foundations.

The proposed treaty will also apply to any taxes that are identical or substantially similar to the taxes described in the preceding paragraph and that are imposed after the signing of the proposed treaty in addition to or in place of existing taxes. This provision generally is found in U.S. income tax treaties. The proposed treaty obligates the competent authority of each country to notify the competent authority of the other country of any changes in its internal taxation or other laws that significantly affect a country's obligation under the proposed treaty.

Article 3. General Definitions

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

The article sets forth its geographical scope with respect to Bulgaria and the United States. In the case of Bulgaria, it encompasses the territory of Bulgaria, including its territorial sea, as well as the continental shelf and the exclusive economic zone over which it exercises sovereign rights and jurisdiction in conformity with international law. In the case of the United States, it encompasses the United States of America, including the States and the District of Columbia, and the territorial sea thereof. It also includes the sea bed and subsoil of the submarine areas adjacent to the territorial sea over which the United States exercises sovereign rights in accordance with international law. The term does not include Puerto Rico, the Virgin Islands, Guam, or any other U.S. possession or territory.

The terms "a Contracting State" and "the other Contracting State" mean Bulgaria or the United States, as the context requires.

The term "person" includes an individual, a company, and any other body of persons. The 2007 proposed protocol clarifies that the term "any other body of persons" includes an estate, trust, or partnership.

The term "company" means a body corporate or an entity treated as a body corporate for tax purposes in the country where it is organized.

The term "enterprise" applies to the carrying on of any business. The term "business" is not defined, but the proposed treaty provides that the term includes the performance of professional services and other activities of an independent character. According to the Technical Explanation, these definitions are intended to clarify that income from the performance of professional services or other activities of an independent character is dealt with under Article 7 (Business Profits) and not Article 20 (Other Income). The proposed treaty further clarifies that the term "business profits" includes income from the performance of professional services and other activities of an independent character.

The terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean, respectively, an enterprise carried on by a resident of a treaty country and an enterprise carried on by a resident of the other treaty country. The Technical Explanation clarifies that an enterprise of a treaty country need not be carried on in that country.

The term “international traffic” means any transport by a ship or aircraft, except when such transport is solely between places within a treaty country. This definition is applicable principally in the context of Article 8 (International Traffic).

The article designates the “competent authorities” for Bulgaria and the United States. In the case of Bulgaria, the competent authority is the Minister of Finance or an authorized representative. The U.S. competent authority is the Secretary of the Treasury or his delegate. According to the Technical Explanation, the Secretary of the Treasury has delegated the competent authority function to the Commissioner of Internal Revenue, who in turn has delegated the authority to the Deputy Commissioner (International) LMSB.

The term “national,” as it relates to the United States and to Bulgaria, means (1) an individual who is a citizen of that country, and (2) any legal person, partnership, or association deriving its status, as such, from the laws of that country. This term is relevant for purposes of Articles 18 (Government Service) and 23 (Non-Discrimination).

The term “pension fund” means any person established in a treaty country that (1) is generally exempt from income taxation in that country, and (2) operates principally to administer or provide pension or retirement benefits or to earn income for the benefit of one or more such arrangements.

The Technical Explanation provides that, in the case of the United States, the term “pension fund” includes the following: a trust providing pension or retirement benefits under a section 401(a) qualified pension plan, profit sharing or stock bonus plan;⁴⁰ a trust providing pension or retirement benefits under a section 403(b) plan; a trust that is an individual retirement account under section 408, a Roth individual retirement account under section 408A, or a simple retirement account under section 408(p); a trust providing pension or retirement benefits under a simplified employee pension plan under section 408(k); a trust described in section 457(g) providing pension or retirement benefits under a section 457(b) plan; and the Thrift Savings Fund (section 7701(j)).

Terms that are not defined in the proposed treaty are dealt with in paragraph 2 of Article 3. Paragraph 2 provides that in the application of the proposed treaty, any term not defined in the proposed treaty will have the meaning that it has under the law of the country whose tax is being applied, unless the context requires otherwise or the competent authorities have agreed on a different meaning pursuant to Article 24 (Mutual Agreement Procedure). If the term is defined under both the tax and non-tax laws of a treaty country, the definition in the tax law prevails.

Article 4. Resident

The assignment of a country of residence is important because the benefits of the proposed treaty generally are available only to a resident of one of the treaty countries as that

⁴⁰ The Technical Explanation further provides that section 401(k) plans and group trusts described in Rev. Rul. 81-100, 1981-1 C.B. 326, and meeting the conditions of Rev. Rul. 2004-67, 2004-2 C.B. 28, qualify as pension funds because they are covered by section 401(a).

term is defined in the proposed treaty. Issues arising because of dual residency, including situations of double taxation, may be avoided by the assignment of one treaty country as the country of residence when under the internal laws of the treaty countries a person is a resident of both countries.

Internal taxation rules

United States

Under U.S. law, an individual who spends sufficient time in the United States in any year or over a three-year period generally is treated as a U.S. resident. A permanent resident for immigration purposes (that is, a “green card” holder) also is treated as a U.S. resident. U.S. residents are taxed on their worldwide income. Under U.S. law, a company is taxed on its worldwide income if it is a “domestic corporation.” A domestic corporation is one that is created or organized in the United States or under the laws of the United States, a State, or the District of Columbia.

Bulgaria

An individual is a resident of Bulgaria if he permanently resides in Bulgaria or spends 183 days in any 365-day period in Bulgaria, regardless of citizenship. Individuals resident in Bulgaria are taxed on their worldwide income. A corporation is a resident of Bulgaria if it is registered under Bulgarian law. Corporations resident in Bulgaria are subject to corporate tax on their worldwide income.

Proposed treaty rules

Article 4 of the proposed treaty provides rules to determine whether a person is a resident of the United States or Bulgaria. The rules generally are consistent with the rules of the U.S. Model treaty.

The proposed treaty generally defines “resident of a Contracting State” to mean any person who, under the laws of that treaty country, is liable to tax therein by reason of the person’s domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature. The term does not include any person who is liable to tax in that country only on income from sources in that country. Further, the proposed 2007 protocol provides that a person who is liable to tax in a treaty country only on profits attributable to a permanent establishment in that country does not become a resident of that country as a result of its permanent establishment.

The proposed treaty makes explicit the generally understood practice of including in the definition of “resident of a Contracting State” the two treaty countries and any political subdivisions or local authorities of those countries.

The proposed 2007 protocol provides an additional rule which references third-country treaties. A company that is or would be a resident of a treaty country under that country’s domestic law will not be treated as a resident of that country for purposes of the treaty if it is treated as a resident of a third country pursuant to an income tax treaty between that treaty

country and the third country. The purpose of this rule is to prevent companies treated as third country residents by one of the treaty countries from obtaining benefits under the proposed treaty. The rule is similar to the rule in paragraph I.(b) of the Understanding accompanying the 2004 protocol that amended the tax treaty between the Netherlands and the United States.⁴¹

The proposed treaty provides a special rule to treat as residents of a treaty country certain legal entities that may be exempt from tax in that country. The provision applies to a pension fund, which is any person established in a treaty country that (1) is generally exempt from income taxation in that country, and (2) operates principally to administer or provide pension or retirement benefits or to earn income for the benefit of one or more such arrangements. In addition, the provision applies to an organization that is established and maintained in a treaty country exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes.

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

The proposed treaty also provides a tie-breaker rule for persons other than individuals (e.g., companies, trusts, or estates). If, under the general residence rules described above, a person other than an individual is a resident of both countries, the proposed treaty requires the competent authorities to endeavor to settle the issue of residence by mutual agreement. If the competent authorities are unable to reach mutual agreement, then that person will not be entitled to claim any benefits provided by the proposed treaty that are limited to residents. A dual resident may, however, claim benefits under the proposed treaty that are not limited to residents, such as those provided by Article 23 (Non-Discrimination).

Fiscally transparent entities

The residence treatment of items of income, profit, or gain derived through fiscally transparent entities is addressed in paragraph 6 of Article 1 (General Scope) of the proposed treaty.

⁴¹ The rule is also consistent with the holding of Rev. Rul. 2004-76, 2004-2 C.B. 111.

Article 5. Permanent Establishment

The proposed treaty contains a definition of the term “permanent establishment” that generally follows the language of other recent U.S. income tax treaties, the U.S. Model, and the OECD Model.

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

In general, under the proposed treaty, a permanent establishment is a fixed place of business in which the business of an enterprise is wholly or partly carried on. A permanent establishment includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or other place of extraction of natural resources. It also includes a building site or a construction or installation project, or an installation used for the exploration for natural resources, if it lasts or if the activity continues in the treaty country for more than six months. The Technical Explanation states that the six-month test applies separately to each individual site or project, with a series of contracts or projects that are interdependent both commercially and geographically treated as a single project. The Technical Explanation further states that if the six-month threshold is exceeded, the site or project constitutes a permanent establishment as of the first day that work in the country began.

The proposed treaty provides that the following activities of a preparatory or auxiliary character are deemed not to constitute a permanent establishment: (1) the use of facilities solely for storing, displaying, or delivering goods or merchandise belonging to the enterprise; (2) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for storage, display, or delivery or solely for processing by another enterprise; and (3) the maintenance of a fixed place of business solely for the purchase of goods or merchandise or for the collection of information for the enterprise. The proposed treaty also provides that the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character does not constitute a permanent establishment. The proposed treaty further provides that a combination of these activities will not give rise to a permanent establishment, if the combination results in an overall activity that is of a preparatory or auxiliary character. These rules are consistent with the OECD and U.S. Model treaties.

The proposed treaty sets forth two circumstances in which a dependent agent of an enterprise constitutes a permanent establishment of the enterprise. First, a dependent agent acting in a treaty country on behalf of an enterprise of the other country is a permanent establishment in the first country if the agent has, and habitually exercises in that first country, the authority to conclude contracts in the name of the enterprise. This rule does not apply where the activities are limited to the preparatory and auxiliary activities described in the two preceding paragraphs. The Technical Explanation states that the language “in the name of the enterprise,” which also appears in the OECD Model treaty, is intended to have the same meaning as the

language “binding on the enterprise” found in the U.S. Model treaty. Both phrases are intended to encompass persons who have sufficient authority to bind the enterprise’s participation in the business activity in the treaty country. Second, even if a dependent agent of an enterprise of one treaty country has no authority to conclude contracts, the dependent agent will give rise to a permanent establishment of the enterprise in the second treaty country if the agent maintains in the second treaty country a stock of goods or merchandise from which the agent regularly fills orders or makes deliveries on behalf of the enterprise, and additional activities conducted in the first treaty country on behalf of the enterprise have contributed to the conclusion of the sale of the goods or merchandise. This second provision is a departure from the U.S. Model treaty but is similar to a provision in the U.N. Model treaty.

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

The proposed treaty provides that the fact that a company that is a resident of one country controls or is controlled by a company that is a resident of the other country or that carries on business in the other country does not cause either company to be a permanent establishment of the other. The Technical Explanation clarifies that, consistent with the U.S. Model treaty, such control is not taken into account in determining whether either company has a permanent establishment in the other treaty country.

Special services rule

The proposed treaty adds a special rule for services in paragraph 8 of this article, under which services performed by an enterprise of a treaty country in the other treaty country may give rise to a permanent establishment in the other country. If paragraph 8 applies, the services are taxed on a net basis under Article VII (Business Profits) of the proposed treaty, and such taxation, therefore, is limited to the profits attributable to the activities carried on in performing those services. According to the Technical Explanation, paragraph 8 applies only to services provided by the enterprise to third parties, and not to services provided to that enterprise (i.e., intercompany services). Neither the U.S. Model treaty nor the OECD Model treaty provides a similar rule for services, although the OECD has issued a draft update to its Model that includes an amendment to the commentary with an example of an alternative permanent establishment provision that is generally similar to paragraph 8, as further described in the Issues section of this document.

Under paragraph 8, subject to paragraph 4 of this article, an enterprise of a treaty country that provides services in the other treaty country, but which does not have a permanent establishment there by virtue of the other provisions of this article, is deemed to provide those services through a permanent establishment in the other treaty country if and only if the enterprise meets one of two tests.

Single individual test

The first test (subparagraph 8(a)) is generally aimed at enterprises that earn most of their income through the personal services of a small number of individuals. The test is employed to determine whether an enterprise of one treaty country is deemed to have a permanent establishment by virtue of the presence of a single individual in the other treaty country. Under subparagraph 8(a), a permanent establishment is deemed to exist if (1) the services are performed in the other treaty country by an individual who is present in the other treaty country for a period or periods aggregating 183 days or more in any 12-month period, and (2) during that period or periods, more than 50 percent of the gross active business revenues of the enterprise consists of income derived from the services performed in the other treaty country by that individual. Both (1) and (2) must be met in order to meet the test of subparagraph 8(a).

According to the Technical Explanation, for purposes of subparagraph 8(a), the term “gross active business revenues” means the gross revenues attributable to active business activities of the enterprise that has been (or should be) charged to its customers, regardless of when the actual billing occurs and of domestic tax law rules concerning when such revenues should be taken into account. Under the test of subparagraph 8(a), such active business activities are not restricted to the activities related to the provision of services (but the term does not include income from passive investment activities).

Enterprise test

Under the second test (subparagraph 8(b)), a permanent establishment is deemed to exist if an enterprise of a treaty country (1) provides services in the other treaty country for an aggregate of 183 days or more in any 12-month period with respect to the same or connected projects, and (2) such services are provided for customers who are either residents of the other treaty country, or maintain a permanent establishment in the other treaty country and the services are provided to such permanent establishment. According to the Technical Explanation, requirement (2) enforces the principle that unless the taxpayer is providing services in the other country to a customer that is either a resident or has a permanent establishment there, such enterprise will not be participating sufficiently in the economic life of that other country to warrant taxation. Both (1) and (2) must be met in order to meet the test of subparagraph 8(b).

Subparagraph 8(b) requires that the services be provided “with respect to the same or connected projects.” The Technical Explanation provides that for purposes of subparagraph 8(b), projects shall be considered to be connected if they constitute a coherent whole, commercially and geographically. These “aggregation rules” are intended, in part, to address potentially abusive situations in which work has been artificially divided into separate components in order to avoid meeting the 183-day threshold. The Technical Explanation states that the determination of whether projects are connected should be made from the point of view of the enterprise and not that of the customer, and depends on the facts and circumstances of each case.

According to the Technical Explanation, in determining the existence of “commercial coherence,” relevant factors (which are not by themselves determinative) include: (1) whether the projects would, in the absence of tax planning considerations, have been concluded pursuant

to a single contract; (2) whether the nature of the work involved under different projects is the same; and (3) whether the same individuals are providing the services under the different projects.

In order to be considered connected, projects must also constitute a coherent whole geographically. The Technical Explanation provides an example of projects that lack geographic coherence in a case in which an enterprise is hired to execute separate auditing projects at different branches of a bank located in different cities pursuant to a single contract. While the projects are commercially coherent, they are not geographically coherent. Thus, each separate auditing project would be considered separately for purposes of subparagraph 8(b).

Physical presence and day counting

Notwithstanding that subparagraph 8(a) refers to services that “are performed” in the other treaty country by an individual who “is present” in the other treaty country for 183 days or more in any 12-month period, and subparagraph 8(b) refers to services that “are provided” in the other treaty country for 183 days or more in any 12-month period, both subparagraphs are intended to apply only to services physically performed in the other treaty country. Thus, the Technical Explanation provides that customer support services provided cross border by telephone or computer would not be covered by paragraph 8, and days in which no individuals of the enterprise are physically in the other treaty country would not count for purposes of the 183-day threshold (for purposes of either subparagraph), even if individuals spend such days working on the project in the country of the enterprise.

The Technical Explanation, however, explains the significance of the differences in the language quoted in the immediately preceding paragraph. Subparagraph 8(a) refers to days in which an individual “is present” in the other country. Accordingly, physical presence of such individual during a day is sufficient, irrespective of whether the individual actually performs work on that day. Subparagraph 8(b), in contrast, refers to days during which services “are provided” by the enterprise in the other treaty country. Thus, days on which no services are actually provided in the other country (such as weekends or holidays in most cases) do not count for purposes of subparagraph 8(b). In addition, the Technical Explanation provides that, for purposes of both subparagraphs, the collective presence of more than one individual providing services during one calendar day will count for only one day of the enterprise’s presence in the other treaty country.

Coordination with other provisions of Article 5

Paragraph 4 of this article provides that certain preparatory or auxiliary activities conducted through a “fixed place of business” solely used for such activities do not give rise to a permanent establishment. Although paragraph 8 does not apply in the case of a “fixed place of business,” the Technical Explanation explains that paragraph 8 does not apply to deem any services to be provided through a permanent establishment if the services are limited to those mentioned in paragraph 4 which, if performed through a fixed place of business, would not make the fixed place of business a permanent establishment under the provisions of that paragraph. The Technical Explanation further explains that, because paragraph 4 applies notwithstanding

paragraph 8, days spent on preparatory or auxiliary activities are not taken into account for purposes of applying subparagraph 8(b).

Administrative issues

The rules of paragraph 8 may give rise to certain administrative issues, including the potential for excess withholding or estimated tax payments with respect to employee wages that may result from the application of paragraph 8 and its interaction with Article 14 (Income from Employment).

Article 6. Income from Immovable Property (Real Property)

This article covers income from immovable property (real property), including income from agriculture or forestry. The rules governing gains from the sale of immovable property (real property) are included in Article 13 (Capital Gains). Under the proposed treaty, income derived by a resident of one country from immovable property (real property) situated in the other country may be taxed in that other country. This rule and, in general, the other rules of this article are consistent with the rules in the U.S. and OECD Model treaties.

The term “immovable property (real property)” generally has the meaning that it has under the law of the country in which the property in question is situated. According to the Technical Explanation, in the case of the United States, the term “real property” has the meaning given to it by Treas. Reg. section 1.897-1(b). The proposed treaty provides, however, that regardless of internal law definitions, immovable property (real property) also includes property accessory to immovable property (real property), including livestock and equipment used in agriculture and forestry; rights to which the provisions of general law respecting landed property apply; usufruct of immovable property (real property); and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources, and other natural resources. Ships and aircraft are not regarded as immovable property (real property).

The proposed treaty specifies that the country in which the property is situated also may tax income derived from the direct use, letting, or use in any other form of immovable property (real property). The rules permitting source-country taxation of income from immovable property (real property) also apply to the income from immovable property (real property) of an enterprise. However, the rules do not apply if the beneficial owner of the income, resident in one treaty country, has a permanent establishment in the other treaty country through which the beneficial owner carries on a business and the income from the immovable property (real property) is effectively connected with that permanent establishment. In such case, the provisions of Article 7 (Business Profits) apply.

The proposed treaty does not grant an exclusive taxing right to the country where the property is located; such country is merely given the primary right to tax. The proposed treaty does not include paragraph 5 of Article 6 of the U.S. Model treaty, regarding the allowance of an election to be taxed on a net basis on income from real property. However, the proposed treaty limits, to 10 percent of the gross amount of the income, the amount of the tax Bulgaria may impose on a resident of the United States with respect to that resident’s income from immovable property (real property) situated in Bulgaria. That limitation applies so long as Bulgarian law

does not permit U.S. residents to make an election to compute the tax on income from immovable property (real property) situated in Bulgaria on a net basis as if such income were business profits attributable to a permanent establishment in Bulgaria. No such limit is imposed on the rate of tax that the United States may impose on a Bulgarian resident because U.S. tax law provides for net-basis taxation of income from real property.

Article 7. Business Profits

Internal taxation rules

United States

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

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

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

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

Special rules apply for purposes of determining the foreign source income that is effectively connected with a U.S. business of an insurance company.

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

Bulgaria

Nonresident individuals are taxed only on their Bulgarian-source income and capital gains. Bulgarian-source income includes income from businesses conducted in Bulgaria; income earned from employment and services performed in Bulgaria; dividends paid by Bulgarian entities; interest; royalties; income paid to directors of Bulgarian entities; rental income and capital gains from property located in Bulgaria; agricultural and forestry income; and payments under leasing, factoring, and franchising agreements. Bulgaria requires a withholding tax on dividends paid by resident companies to nonresident individuals at a rate of five percent.

A foreign company is subject to the Bulgarian corporate tax on income derived through a permanent establishment in Bulgaria. A permanent establishment is any place of business through which the foreign company conducts, either wholly or partly, its business activities in Bulgaria. The activities of a nonresident's dependent agent also are deemed to constitute a permanent establishment, as is a place of continuous commercial activity.

Proposed treaty limitations on internal law

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

Although the proposed treaty does not provide a definition of the term "business profits," the Technical Explanation states that the term is intended to cover income derived from any trade or business, including income from personal services performed by the enterprise. Accordingly, a consulting firm resident in one treaty country whose employees or partners perform services in the other treaty country through a permanent establishment may be taxed in that other country under Article 7, and not under Article 14 (Income from Employment) because that article applies only to income of employees. The employees' income, however, is subject to Article 14. The term "business profits" also includes income attributable to notional principal contracts and other financial instruments to the extent that the income is attributable to a trade or business of dealing in such instruments or is otherwise related to a trade or business (as in the case of a notional

principal contract entered into for the purpose of hedging currency risk arising from an active trade or business). Any other income derived from financial instruments is, according to the Technical Explanation, addressed in Article 20 (Other Income), unless specifically governed by another article.

The proposed treaty, as elaborated by the proposed 2007 protocol and the Technical Explanation, provides rules for the attribution of business profits to a permanent establishment. Under these rules, the treaty countries attribute to a permanent establishment the business profits that the permanent establishment might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions, and dealing wholly independently with the enterprise of which it is a permanent establishment. For this purpose, the business profits to be attributed to the permanent establishment include only the profits derived from the assets used, risks assumed, and activities performed by the permanent establishment. The proposed 2007 protocol and the Technical Explanation make clear that the principles of the OECD Transfer Pricing Guidelines apply for purposes of determining the profits attributable to a permanent establishment, but taking into account the different economic and legal circumstances of a single entity. The Technical Explanation notes that this rule confirms the arm's length standard for purposes of determining the profits attributable to a permanent establishment. Any of the methods described in the Transfer Pricing Guidelines, including profits methods, may be used to determine the income of the permanent establishment as long as those methods are applied in accordance with the Transfer Pricing Guidelines.

In applying the arm's-length standard to determine the taxable business profits of a permanent establishment, the Technical Explanation observes that it is necessary to draw an economic (as well as legal) distinction between operating through a single legal entity rather than through separate legal entities. For example, an entity that operates through branches rather than separate subsidiaries will have lower capital requirements because all of the assets of the entity are available to support all of the entity's liabilities (with some exceptions attributable to local regulatory restrictions). Thus, most commercial banks and some insurance companies operate through branches rather than subsidiaries. While the benefit that comes from such lower capital costs must be allocated among the branches in an appropriate manner, this issue does not arise in the case of an enterprise that operates through separate entities because each entity must either be capitalized separately or compensate another entity for providing capital (e.g., through a guarantee).

The Technical Explanation states that, whereas U.S. domestic law does not recognize internal transactions because they do not have legal significance, the rule provided by the proposed treaty is that such internal dealings may be used to allocate income in cases where the dealings accurately reflect the allocation of risk within the enterprise. For example, in the case of global dealing in securities, many banks use internal swap transactions to transfer risk from one branch to a central location where traders have the expertise to manage that particular type of risk. Under the proposed treaty, such banks also are permitted to use swap transactions as a means of allocating income between or among the branches, provided the allocation method used by the bank complies with the transfer pricing rules of U.S. internal law. However, the books of a branch will not be respected if the results are inconsistent with a functional analysis. For example, income from a transaction that is booked in a particular branch (or home office) would

not be allocated to that location if the sales and risk management functions that generate such income are performed in another location.

A permanent establishment cannot be funded entirely with debt, but must have sufficient capital to carry on its activities as if it were a distinct and separate enterprise. In general, if insufficient capital has been attributed to a permanent establishment for profit attribution purposes, a treaty country may attribute such capital to the permanent establishment, in accordance with the arm's-length principle, and deny an interest deduction to the extent necessary to reflect that capital attribution. According to the Technical Explanation, both U.S. internal law and the proposed treaty start from the premise that all of the capital of the enterprise supports all of the assets and risks of the enterprise, and therefore the entire capital of the enterprise must be allocated to its various businesses and offices.

The Technical Explanation notes, however, that U.S. internal law⁴² does not take into account the fact that some assets are more risky than other assets, and that, for example, an independent enterprise would require less capital to support a perfectly hedged U.S. Treasury security than it would to support an equity security or other asset with significant market and/or credit risk. Thus, U.S. internal law requires taxpayers in some cases to allocate more capital to the United States (and, thus, reduces the taxpayer's interest deduction more) than may be appropriate. To address these cases, the Technical Explanation states that the proposed treaty permits taxpayers to apply a more flexible approach that takes into account the relative risk of its assets in the various jurisdictions in which it conducts business. In particular, with respect to financial institutions other than insurance companies, the proposed 2007 protocol provides that a treaty country may determine the amount of capital to be attributed to a permanent establishment by allocating the institution's total equity between its various offices on the basis of the proportion of the financial institution's risk-weighted assets attributable to each of them. However, to ease the administrative burden arising because risk-weighting is more complicated than the method prescribed under U.S. internal law, the Technical Explanation also states that taxpayers may choose to apply the principles of U.S. internal law, rather than risk-weighted attribution, even if the taxpayer has otherwise chosen to apply Article 7 in lieu of the effectively connected income rules of U.S. internal law.

With respect to insurance companies, the proposed 2007 protocol provides that the profits attributable to a permanent establishment include that portion of the companies' overall investment income from reserves and surplus that supports the risks assumed by the permanent establishment, as well as premiums earned through the permanent establishment.

The proposed treaty provides that in computing taxable business profits of a permanent establishment, deductions are allowed for expenses, wherever incurred, that are for the purposes of the permanent establishment. These deductions include executive and general administrative expenses so incurred. The Technical Explanation states that deductions are allowed regardless of which accounting unit of the enterprise books the expenses, so long as the expenses are incurred for the purposes of the permanent establishment (including for the purposes of the enterprise as a

⁴² Treas. Reg. sec. 1.882-5.

whole or that part of the enterprise that includes the permanent establishment). The amount of expense that must be allowed as a deduction is determined by applying the arm's-length principle. The Technical Explanation states that a permanent establishment may deduct payments made to its head office or another branch in compensation for services performed for the benefit of the branch, provided the deduction comports to the arm's-length standard. The method for computing the amount of such a deduction would depend upon the terms of the arrangements between the branches and head office.

The Technical Explanation states that, if a deduction would be allowed under the Code in computing taxable income, the deduction is also allowed in computing taxable income under the proposed treaty. However, except where the proposed treaty provides for more favorable treatment, a taxpayer cannot take deductions for expenses in computing taxable income under the proposed treaty to a greater extent than would be allowed under the Code where doing so would be inconsistent with the intent of the Code. For example, if a Bulgarian taxpayer with a permanent establishment in the United States borrows \$100 to purchase U.S. tax-exempt bonds, and the bonds and related debt would be treated as assets and liabilities of the permanent establishment, both the tax-exempt interest from the bonds and the interest expense from the related debt would be excluded for purposes of computing the profits attributable to the permanent establishment under the proposed treaty.

Like the U.S. and OECD Model treaties, the proposed treaty provides that business profits are not attributed to a permanent establishment merely by reason of the purchase of goods or merchandise by the permanent establishment for the enterprise of which it is a part. According to the Technical Explanation, this rule applies only to an office that performs functions in addition to purchasing because purchasing does not by itself give rise to a permanent establishment under Article 5 (Permanent Establishment) to which income can be attributed. When it applies, the rule provides that business profits may be attributable to a permanent establishment for its non-purchasing activities (e.g., sales activities), but not for its purchasing activities.

The proposed treaty requires that the determination of the business profits of a permanent establishment be made using the same method year by year unless there is a good and sufficient reason to the contrary. The Technical Explanation states that this rule limits the ability of both the treaty country and the enterprise to change accounting methods to be applied to the permanent establishment.

Where business profits include items of income that are dealt with separately in other articles of the proposed treaty, those other articles, and not the business profits article, generally govern the treatment of those items of income. Thus, for example, the taxation of dividends is determined under the rules of Article 10 (Dividends), and not by the rules of Article 7, except as specifically provided in Article 10 (that is, when dividends are attributable to a permanent establishment).

The proposed treaty provides that, for purposes of the taxation of business profits, income may be attributable to a permanent establishment (and therefore may be taxable in the source country) even if the payment of the income is deferred until after the permanent establishment has ceased to exist. This rule incorporates into the proposed treaty the rule of section 864(c)(6)

described above. This rule applies for purposes of the rules for business profits under this article, income from real property (Article 6, paragraph 4), dividends (Article 10, paragraph 6), interest (Article 11, paragraph 5), royalties (Article 12, paragraph 4), gains (Article 13, paragraph 3) and other income (Article 20, paragraph 2).

The Technical Explanation notes that Article 7 is subject to the saving clause of paragraph 4 of Article 1 (General Scope). Thus, in the case of the saving clause, if a U.S. citizen who is a resident of Bulgaria derives business profits from the United States that are not attributable to a permanent establishment in the United States, the United States may, subject to the special foreign tax credit rules of paragraph 4 of Article 22 (Relief from Double Taxation), tax those profits, notwithstanding that paragraph 1 of this article would exempt the income from U.S. tax.

Article 8. International Traffic

Article 8 of the proposed treaty covers income from the operation of ships and aircraft in international traffic. The rules governing income from the disposition of ships, aircraft, and containers are in paragraphs 4 and 5 of Article 13 (Gains).

The United States generally taxes the U.S.-source income of a foreign person from the operation of ships or aircraft to or from the United States. An exemption from U.S. tax is provided if the income is earned by a corporation or nonresident alien individual organized or resident in a foreign country that grants an equivalent exemption to U.S. corporations and residents. Bulgaria is considered to grant an equivalent exemption.⁴³

The proposed treaty provides that profits of an enterprise of one treaty country from the operation of ships or aircraft in international traffic are taxable only in that country. Paragraph 6 of Article 7 (Business Profits) provides that if profits include items of income that are described in both Article 7 and other articles of the proposed treaty, including Article 8, the provisions of those other articles are not affected by the provisions of Article 7. The rules of Article 8, therefore, are not affected by the general rule of Article 7 that profits attributable to a permanent establishment that an enterprise of a treaty country has in the other treaty country may be taxed in the other treaty country. Consequently, the profits of an enterprise of a treaty country from the operation of ships or aircraft in international traffic may not be taxed in the other treaty country even if the enterprise has a permanent establishment in that other treaty country.

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

Like the U.S. Model, the proposed treaty provides that profits from the operation of ships or aircraft in international traffic include, but are not limited to, profits derived from the rental of ships or aircraft on a full basis (i.e., rental with crew, whether on a time or voyage basis) and profits from the rental of ships or aircraft on a bareboat basis (that is, without crew) if the rental

⁴³ See Rev. Rul. 2008-17, 2008-12 I.R.B. 626 (Mar. 24, 2008).

income is incidental to the lessor's other profits from the operation of ships or aircraft in international traffic.

The proposed 2007 protocol provides, consistent with the U.S. Model, that profits of an enterprise from the transport of tangible property or passengers within either treaty country are treated as profits from the operation of ships or aircraft in international traffic (and, therefore are governed by Article 8) if the transport is undertaken as part of international traffic. Thus, according to the Technical Explanation, if a U.S. shipping company contracts to carry property from Bulgaria to a U.S. city and as part of that contract transports the property by truck from its point of origin to an airport in Bulgaria (or contracts with a trucking company to carry the property to the airport), the income earned by the U.S. company from the overland leg of the transport is taxable only in the United States. Similarly, the Technical Explanation states that Article 8 also applies to all income derived from a contract for the international transport of goods even if the goods are transported to the port by a lighter (a barge used in loading and unloading ships), and not by the vessel that carries the goods in international waters.

The proposed treaty provides that profits of an enterprise of a treaty country from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) used for the transport of goods or merchandise are taxable only in that treaty country except to the extent those containers are used for transport solely between places in the other treaty country. According to the Technical Explanation, this exclusive residence country taxation applies even if the enterprise is not engaged in the operation of ships or aircraft in international traffic and even if the enterprise has a permanent establishment in the other treaty country.

As under the U.S. Model treaty, the shipping and air transport provisions of the proposed treaty apply to profits from participation in a pool, a joint business, or an international operating agency. These arrangements are common methods of cooperation among international shipping and air transport companies.

The Technical Explanation notes that Article 8 is subject to the saving clause of paragraph 4 of Article 1 (General Scope). Consequently, if a U.S. citizen who is a resident of Bulgaria derives profits from the operation of ships or aircraft in international traffic, the United States may tax those profits as part of the citizen's worldwide income (subject to the proposed treaty's foreign tax credit rules). The benefit of exclusive residence country taxation is available to an enterprise of a treaty country only if that enterprise satisfies the limitation on benefits requirements of Article 21.

Article 9. Associated Enterprises

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

treatment is consistent with the U.S. and OECD Model treaties, as well as most existing U.S. treaties.

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

Under the proposed treaty, when a redetermination of tax liability has been made by one treaty country under the provisions of this article, and the other treaty country agrees with that redetermination, then that other treaty country will make an appropriate adjustment to the amount of tax paid in that country on the redetermined income. This secondary adjustment is known as a correlative, or corresponding, adjustment. In making a correlative adjustment, consideration must be given to whether other provisions of the proposed treaty apply to that adjustment. For example, if the correlative adjustment would be treated as a dividend from the United States to Bulgaria, then the provisions of Article 10 (Dividends) may apply. The proposed treaty's saving clause, which retains full taxing jurisdiction in the country of residence or citizenship, does not apply in the case of correlative adjustments. Accordingly, internal statute of limitations rules do not prevent the allowance of appropriate correlative adjustments. However, the Technical Explanation states that statutory or procedural limitations cannot be overridden to impose additional tax because paragraph 2 of Article 1 (General Scope) provides that the proposed treaty cannot restrict any statutory benefit.

Article 10. Dividends

Overview

The dividends article of the proposed treaty generally allows full residence-country taxation and limited source-country taxation of dividends. The proposed treaty includes a generally applicable maximum rate of withholding at source of 10 percent and a reduced five-percent maximum rate for dividends received by a company owning at least 10 percent of the dividend-paying company. A zero rate of withholding tax generally applies to dividends received by pension funds. Special rules apply to dividends received from RICs and REITs. These special rules are similar to provisions included in other recent treaties and protocols.

Internal taxation rules

United States

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

Under U.S. law, the term "dividend" generally means any distribution of property made by a corporation to its shareholders from current or accumulated earnings and profits.

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

A REIT is a U.S. domestic corporation, trust, or association that is subject to the regular corporate income tax, but that receives a deduction for dividends paid to its shareholders if certain conditions are met. To qualify for the deduction for dividends paid, a REIT must distribute most of its income. As a result of the deduction for dividends paid, a REIT generally does not pay Federal income tax. Except for capital gain dividends, a distribution of REIT earnings is generally treated by the recipient as a dividend rather than as income of the same type as the underlying earnings.⁴⁴ This distribution is subject to the U.S. 30-percent withholding tax when paid to foreign owners. However, the receipt of a distribution from a REIT is generally treated as a disposition of a U.S. real property interest by the recipient to the extent that it is attributable to a sale or exchange of a U.S. real property interest by the REIT.⁴⁵

REITs generally are organized to allow investment in primarily passive real estate investments. As such, income of a REIT often includes rentals from real estate holdings or interest from loans secured by real estate mortgages. Like dividends, U.S.-source rental income of foreign persons generally is subject to the 30-percent withholding tax (unless the recipient makes an election to have the rental income taxed in the United States on a net basis at the regular graduated rates). Unlike the withholding tax on dividends, however, the withholding tax on rental income generally is not reduced in U.S. income tax treaties. When rental income (or interest income) of a REIT is distributed to a foreign shareholder as a REIT dividend, it is treated as a dividend under U.S. internal law. U.S.-source interest income of foreign persons is not subject to U.S. withholding tax in certain circumstances. A REIT dividend does not, however, pass through to the REIT's shareholders the interest characterization of the REIT's underlying earnings.

U.S. internal law also generally treats a RIC as both a corporation and as an entity not subject to corporate tax to the extent it distributes substantially all of its income. The purpose of a RIC is to allow investors to hold diversified portfolios of securities. Dividends paid by a RIC

⁴⁴ Because a REIT generally does not pay corporate-level tax, certain U.S. benefits of dividend treatment are not available. A U.S. corporate shareholder is not generally entitled to a dividends-received deduction for REIT dividends. REIT dividends generally are not qualified dividends eligible for the 15-percent rate available for individual shareholders.

⁴⁵ There is an exception for distributions to a shareholder that owns five percent or less of the REIT, if the REIT stock is regularly traded on an established securities market located in the United States. Sec. 897(h)(1). These distributions are treated as dividends under U.S. internal law.

generally are treated as dividends received by the payee, and the RIC generally pays no tax because it is permitted to deduct dividends paid to its shareholders in computing its taxable income. However, a RIC generally may pass through to its shareholders the character of its net long-term and, for taxable years beginning before January 1, 2008, net short-term capital gains by designating a dividend it pays as a long-term or short-term capital gain dividend, to the extent that the RIC has net capital gains. Nonresident aliens and foreign corporations generally are not subject to tax on capital gains. A distribution in a taxable year beginning before January 1, 2008 to a nonresident alien or foreign corporation made by a RIC that is (or, if certain exceptions were disregarded, would be) a U.S. real property holding corporation, however, is treated as gain recognized by that nonresident alien or foreign corporation from the sale or exchange of a U.S. real property interest to the extent the gain is attributable to gain from sales or exchanges of U.S. real property interests.⁴⁶

A RIC that earns interest income that would not be subject to U.S. tax if earned by a foreign person directly (“qualified interest income”)⁴⁷ generally may designate a dividend it pays in a taxable year beginning before January 1, 2008 as derived from that interest income, to the extent of that income. Nonresident aliens and foreign corporations are not subject to tax on such interest-related dividends. The aggregate amount that may be designated by a RIC as interest-related dividends generally is limited to the sum of qualified interest income less the amount of expenses of the RIC properly allocable to the interest income.

Bulgaria

Dividends paid by Bulgarian resident companies to nonresident individuals and companies generally are subject to withholding tax at a five-percent rate. However, dividends paid by a Bulgarian resident company to an EU company covered by the EC Parent-Subsidiary Directive generally are exempt from withholding if the recipient company holds at least 15 percent of the Bulgarian company continuously for at least two years. If the recipient company is a Swiss company, the Swiss company generally must hold at least 25 percent of the Bulgarian company continuously for two years to qualify for the exemption from withholding.

⁴⁶ The exception described in the immediately preceding footnote also applies for distributions by RICs.

⁴⁷ Qualified interest income of the RIC is equal to the sum of its U.S.-source income with respect to: (1) bank deposit interest; (2) short term original issue discount that is currently exempt from the gross-basis tax under section 871; (3) any interest (including amounts recognized as ordinary income in respect of original issue discount, market discount, or acquisition discount under the provisions of sections 1271-1288, and such other amounts as regulations may provide) on an obligation that is in registered form, unless it is earned on an obligation issued by a corporation or partnership in which the RIC is a 10-percent shareholder or is contingent interest not treated as portfolio interest under section 871(h)(4); and (4) any interest-related dividend from another RIC.

Proposed treaty limitations on internal law

In general

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

The term “beneficial owner” is not defined in the proposed treaty and therefore is defined under the internal law of the country imposing tax (that is, the source country). The Technical Explanation states that the beneficial owner of a dividend for purposes of this article is the person to which the dividend income is attributable for tax purposes under the laws of the source country.

According to the Technical Explanation, however, special rules apply to companies holding shares through fiscally transparent entities, such as partnerships. In such cases, the rules of paragraph 6 of Article 1 (General Scope) of the proposed treaty apply to determine whether the dividends should be treated as derived by a resident of a treaty country. The laws of the residence country determine who derives the dividend, and the laws of the source country determine whether the person who derives the dividends is the beneficial owner of the dividends. The principles of paragraph 6 of Article 1 (General Scope) of the treaty also apply to determine whether other requirements have been satisfied, such as the ownership threshold that must be met to qualify for the five-percent rate under this article.

The proposed treaty provides a zero rate of withholding tax for dividends received by a pension fund, provided that the dividends are not derived from the carrying on of a business by the fund or through an associated enterprise. The proposed treaty defines a pension fund as a person established in Bulgaria or the United States that is operated principally to administer or provide pension or retirement benefits or to earn income for the benefit of one or more such arrangements and that is generally exempt from taxation in the treaty country in which it is established.

Dividends paid by U.S. RICs and REITs

The proposed treaty generally denies the five-percent rate of withholding tax to dividends paid by U.S. RICs and REITs.

The 10-percent rate of withholding generally is allowed for dividends paid by a RIC. The 10-percent rate of withholding is allowed for dividends paid by a REIT, provided one of three additional conditions is met: (1) the beneficial owner of the dividend is an individual or a pension fund, in either case holding an interest of not more than 10 percent in the REIT; (2) the dividend is paid with respect to a class of stock that is publicly traded, and the beneficial owner of the dividend is a person holding an interest of not more than five percent of any class of the

REIT's stock; or (3) the beneficial owner of the dividend holds an interest in the REIT of not more than 10 percent, and the REIT is diversified (that is, the value of no single interest in real property held by the REIT exceeds 10 percent of the total interests of the REIT in real property).

The Technical Explanation indicates that the restrictions on availability of the lower rate are intended to prevent the use of RICs and REITs to gain inappropriate U.S. tax benefits. For example, a company resident in Bulgaria could directly own a diversified portfolio of U.S. corporate shares and pay a U.S. withholding tax of 10 percent on dividends on those shares. Absent the additional RIC restrictions, there is a concern that such a company instead might purchase 10 percent or more of the interests in a RIC, which could even be established as a mere conduit, and thereby obtain a lower withholding tax rate by holding the portfolio through the RIC (transforming portfolio dividends generally taxable at 10 percent into direct investment dividends taxable under the treaty at five percent).

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

Definitions and special rules and limitations

The proposed treaty generally defines dividends as income from shares or other corporate participation rights that are not treated as debt, as well as other amounts that are subject to the same tax treatment by the source country as income from shares (for example, constructive dividends).

The proposed treaty's reduced rates of tax on dividends do not apply if the dividend recipient carries on business through a permanent establishment in the source country and the holding in respect of which the dividends are paid is effectively connected with that permanent establishment. In this case, the dividends are taxed as business profits (Article 7).

The proposed treaty prevents each treaty country from imposing a tax on dividends paid by a resident of the other treaty country unless the dividends are paid to a resident of the first country or are attributable to a permanent establishment in that country.

The proposed treaty allows each treaty country to impose a branch profits tax on a company that has income attributable to a permanent establishment in that country, derives income from real property in that country that is taxed on a net basis under the treaty, or realizes gains taxable in that country under the treaty. In the case of the United States, the tax is limited to the "dividend equivalent amount," consistent with the branch profits tax under U.S. internal law (section 884). In the case of Bulgaria, the tax is limited to an amount that is analogous to the dividend equivalent amount. The rate of branch profits tax is limited to five percent.

Relation to other articles

The Technical Explanation notes that the saving clause of paragraph 4 of Article 1 of the treaty (General Scope) permits the United States to tax dividends received by its residents and citizens, subject to the special foreign tax credit rules of paragraph 4 of Article 22 (Relief from Double Taxation), as if the proposed treaty had not come into effect.

The benefits of the dividends article are also subject to the provisions of Article 21 of the treaty (Limitation on Benefits).

Article 11. Interest

Internal taxation rules

United States

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

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

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

Bulgaria

Bulgaria-source interest payments made to nonresident individuals and foreign corporations generally are subject to withholding tax in Bulgaria at a 10-percent rate.

Proposed treaty limitations on internal law

The proposed treaty restricts the ability of each treaty country to tax interest income arising in that country (the source country) when that interest income is beneficially owned by a resident of the other treaty country (the residence country). The proposed treaty generally permits full residence-country taxation of interest income and allows the source country to tax the interest income at a rate not exceeding five percent of the gross amount of the interest. The allowance of source-country taxation of interest income contrasts with the U.S. Model's general rule of exclusive residence-country taxation.

Although the source country is generally permitted to tax interest income at a five-percent rate on the gross amount of the interest, in certain circumstances, the proposed treaty forbids source-country taxation. Source-country taxation of interest income is not permitted if (1) the interest income is beneficially owned by the government of the other treaty country, by a political subdivision or a local authority (for example, a State or local government) in that other country, or by the central bank of the other treaty country or any institution wholly owned by that country; (2) the interest income is beneficially owned by a resident of the other treaty country and is derived in relation to debt-claims guaranteed, insured, or indirectly financed by the government of that other treaty country, by a political subdivision or a local authority (for example, a State or local government) in that other country, or by the central bank of the other treaty country or any institution wholly owned by that country; (3) the interest is beneficially owned by a financial institution, including for example a bank or an insurance company, that is a resident of the other treaty country unless the interest is paid as part of a back-to-back loan or an arrangement that is economically similar to and has the effect of a back-to-back loan; or (4) the interest is beneficially owned by a pension fund that is a resident of the other treaty country unless the interest is derived from the pension's fund direct or indirect carrying on of a business.

The proposed 2007 protocol explains that the exception from exclusive source-country taxation of interest income of a financial institution paid as part of a back-to-back loan applies to a loan that is structured to obtain exclusive source-country taxation by having designated as the borrower a financial institution that in turn lends the funds directly to the ultimate intended borrower. The Technical Explanation states that the reference to arrangements that are economically similar to back-to-back loans is intended to reach instruments that do not satisfy the legal requirements of a loan, instruments such as securities issued at a discount or certain swap arrangements. The Technical Explanation also notes that nothing in Article 11 is intended to restrict a treaty country in enforcing its internal law anti-avoidance rules.

The proposed treaty defines interest as income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits. In particular, interest includes income from government securities and from bonds or debentures, including premiums and prizes attaching to those securities, bonds, or debentures. The term "interest" also includes all other income that is treated as income from money lent

under the tax law of the treaty country in which the income arises. Interest does not include income covered in Article 10 (Dividends). Penalty charges for late payment also are not treated as interest.

The limitations in Article 11 on a source-country's taxation of interest income do not apply if the beneficial owner of the interest carries on business through a permanent establishment in that source country and the debt-claim in respect of which the interest is paid is effectively connected with that permanent establishment. (The Technical Explanation describes interest as being "attributable to" the permanent establishment, a common usage in U.S. income tax treaties, rather than adopting the U.S. Model's phrase that a debt-claim is "effectively connected with" a permanent establishment.) In that circumstance, the interest is taxed as business profits (Article 7). According to the Technical Explanation, interest attributable to a permanent establishment but received after the permanent establishment is no longer in existence is taxable in the country in which the permanent establishment existed.

The proposed treaty includes a rule for determining the source of interest. Interest generally is deemed to arise in the payor's country of residence. If, however, the person paying the interest has a permanent establishment in a treaty country, the indebtedness on which the interest is paid was incurred in connection with that permanent establishment, and the interest is borne (that is, is deductible) by that permanent establishment, the interest is deemed to arise in the treaty country in which the permanent establishment is situated. This source rule is equivalent to the rule in the OECD Model.

The proposed treaty addresses non-arm's-length interest charges between a payor and a beneficial owner that have a special relationship. Paragraph 7 of Article 11 provides that the article applies only to the amount of interest that would have been agreed in the absence of a special relationship. Any excess amount is taxable according to the laws of each treaty country, with due regard being given to other provisions of the proposed treaty. For example, excess interest paid to a parent corporation may be treated as a dividend under a country's internal laws and, accordingly, would be entitled to the benefits of Article 10 (Dividends). The Technical Explanation notes that the term "special relationship" is not defined in the proposed treaty and states that the United States considers the term to include the relationships described in Article 9 (Associated Enterprises). Those relationships, according to the Technical Explanation, involve control as defined under the transfer pricing rules of section 482.

The proposed treaty provides two anti-abuse exceptions to the general source-country exemption from tax on interest.⁴⁸ The first exception relates to contingent interest payments. The rules for interest arising in the United States and interest arising in Bulgaria are stated differently. Interest arising in the United States that is contingent interest of a type that does not qualify as portfolio interest under U.S. law may be taxed in the United States. The Technical Explanation states that contingent interest is defined by reference to Code section 871(h)(4) and that the exceptions from contingent interest under section 871(h)(4)(C) apply. If interest arising

⁴⁸ The 2008 protocol includes a clerical correction to an internal cross-reference made in this rule.

in Bulgaria is determined with reference to (1) receipts, sales, income, profits, or other cash flow of the debtor or a related person, (2) any change in the value of any property of the debtor or a related person, or (3) any dividend, partnership distribution, or similar payment made by the debtor or a related person, the interest may be taxed in Bulgaria in accordance with Bulgarian law. If the beneficial owner of contingent interest arising in either the United States or Bulgaria is a resident of the other treaty country, the interest may not be taxed at a rate exceeding 10 percent of the gross amount of the interest (that is, the rate prescribed in Article 10 for dividends derived by less-than-10-percent shareholders).

The second anti-abuse exception provides that the exemption from source-country taxation does not apply to interest that is an excess inclusion with respect to a residual interest in a REMIC. That interest may be taxed by each treaty country in accordance with its domestic law. The Technical Explanation states that this exception is consistent with the policy of sections 860E(e) and 860G(b) that excess inclusions with respect to a REMIC should bear full U.S. tax in all cases.

The proposed treaty includes a rule that permits each treaty country to impose a branch-level interest tax on a corporation resident in the other treaty country. Under this rule, a treaty country may tax an amount that is deemed to be interest equal to the excess of (1) interest deductible in that country in computing the profits of a corporation that are subject to tax in that country and that are either attributable to a permanent establishment in that country or subject to tax in that country under Article 6 or Article 13 over (2) the interest actually paid by the permanent establishment in that treaty country. The treaty country may tax that excess amount as if the deemed interest arose in that country and were beneficially owned by a resident of the other country. The deemed interest thus may, unless one of the exemptions from source-country taxation applies, be taxed at a rate not exceeding the five-percent rate generally permitted to a source country.

The proposed 2007 protocol notes that the proposed treaty permits source-country taxation of interest (and royalties). Under that protocol, the treaty countries agree at an appropriate time to reconsider this source-country taxation of interest (and royalties) arising in Bulgaria and beneficially owned by a resident of the United States. This reconsideration will, according to the proposed protocol, be consistent with the December 31, 2014 conclusion of the transition period under the European Union Council Directive 2003/49/EC of June 3, 2003 (addressing a common system of taxation of interest and royalty payments made between associated companies of different member states of the European Union) applicable to interest and royalties deemed to arise in Bulgaria and beneficially owned by a resident of the European Union.

The Technical Explanation notes that the benefits of Article 11, like benefits provided by other articles, are subject to the saving clause of paragraph 4 of Article 1 (General Scope) and are available only if a resident satisfies the limitation-on-benefits requirements of Article 21.

Article 12. Royalties

Internal taxation rules

United States

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

Bulgaria

Royalties paid to nonresidents are generally subject to a 10-percent withholding rate.

Proposed treaty limitations on internal law

The proposed treaty provides that royalties arising in a treaty country (the source country) and beneficially owned by a resident of the other treaty country (the recipient country) may be taxed by either country. This differs from the U.S. and OECD Model treaties, which generally grant the exclusive right of taxation to the recipient country. However, the proposed treaty limits taxation by the source country to a five-percent withholding tax.

The term “royalties” as used in this article means payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work (including cinematographic films and films, tapes or other means of image or sound reproduction for radio or television broadcasting), any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial, or scientific experience. In addition, income from the disposition of any property or right described above constitutes royalty income to the extent that the amounts realized on the disposition are contingent on the productivity, use, or further disposition of such property or right. The Technical Explanation points out that income derived from renting tangible personal property is not considered as royalties.

Consistent with the U.S. and OECD Model treaties, the term “royalties” does not expressly include computer software. According to the Technical Explanation, this position reflects that consideration for the use, or right to use, computer software may be categorized as either as royalties or as business profits, depending on the facts and circumstances of the underlying transaction. If the consideration is categorized as a royalty, then the provisions of Article 12 (Royalties) apply because computer software is generally protected by copyright rules. If the consideration is categorized as business profits, then the provisions of Article 7 (Business Profits) apply. The most important factor in establishing whether such consideration is a royalty or business profit is the nature of the rights transferred, as further described in Treas. Reg. section 1.861-18. When evaluating the facts and circumstances, the characterization of the transaction for purposes of copyright law is not relevant, nor is the means by which the computer software is transferred. For example, the Technical Explanation states that a typical retail sale of “shrink wrap” computer software will not be considered as royalty income (even though for copyright law purposes it may be characterized as a license).

The five-percent withholding rate provided in paragraph 4 of the proposed treaty does not apply if the beneficial owner of the royalties carries on a business through a permanent establishment in the source country, and the right or property with respect of which the royalties are paid is effectively connected with such permanent establishment. In that event, the royalties are taxed as business profits (Article 7). Similarly, the Technical Explanation states that royalties attributable to a permanent establishment under paragraph 5 of the proposed treaty, but received after the permanent establishment is no longer in existence are also taxable as under the business profits provisions (under Article 7) in the country where the permanent establishment existed. In addition, paragraph 5 of the proposed treaty states that royalties for the use of, or for the right to use, property in one treaty country are considered as arising in (and therefore are subject to tax by) that treaty country - even if the payor is not a resident of either the United States or Bulgaria.

The proposed treaty addresses the issue of non-arm's-length royalties between related parties (or parties otherwise having a special relationship) by providing that this article applies only to the amount of arm's-length royalties. Any amount of royalties paid in excess of arm's length is taxable according to other provisions of the proposed treaty. For example, excess royalties paid by a subsidiary corporation to its parent corporation may be treated as a dividend under local law and, thus, entitled to the benefits of Article 10 (Dividends).

The protocol to the proposed treaty contains a special provision reflecting the circumstances under which Bulgaria joined the European Union.⁴⁹ Under a transitional regime, the European Union authorized Bulgaria to defer implementing European Union Council Directive 2003/49/EC of June 3, 2003 regarding withholding taxes on royalties until December 31, 2014. As stated in paragraph 7 of the proposed 2007 protocol, the United States and Bulgaria have agreed to revisit the imposition of royalty withholding taxes on royalties at the end of that transition period.

Article 13. Capital Gains

Internal taxation rules

United States

Generally, gain realized from the sale of a capital asset by a nonresident alien individual or a foreign corporation 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 sale by a nonresident alien individual, that individual is physically present in the United States for at least 183 days in the taxable year. A nonresident alien individual or foreign corporation generally is subject to U.S. tax on gain from the sale of a U.S. real property interest as if the gain were effectively connected with a trade or business conducted in the United States. "U.S. real property interests" include interests in certain corporations if U.S. real property comprises at least 50 percent of the assets of the corporation.

⁴⁹ Bulgaria joined the EU on January 1, 2007.

Bulgaria

Bulgarian-source capital gains derived by nonresident individuals and companies from the sale of immovable property and securities (except quoted shares sold through the Bulgarian Stock Exchange) generally are subject to a 10-percent tax by Bulgaria.

Proposed treaty limitations on internal law

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

Under the proposed treaty, gains derived by a resident of one treaty country that are attributable to the alienation of immovable property (real property) situated in the other country may be taxed in that other country. The Technical Explanation states that the proposed treaty phrase “[g]ains . . . attributable to the alienation of immovable property (real property)” is used instead of the OECD Model treaty phrase “gains from the alienation” to clarify that the United States treats distributions made by a REIT and certain RICs as taxable under Article 13, not under Article 10 (Dividends), when those distributions are attributable to gains derived from the alienation of U.S. real property interests by the REIT or RIC.

For the purposes of this article, immovable property (real property) situated in the other treaty country includes: (1) immovable property (real property) referred to in Article 6 (Income from Immovable Property (Real Property))—that is, an interest in the immovable property (real property) itself; (2) in the case of the United States, a U.S. real property interest; and (3) in the case of Bulgaria, (a) shares, including rights to acquire shares, that are not regularly traded on an established securities market that derive more than 50 percent of their value directly or indirectly from immovable property (real property) referred to in Article 6 (Income from Immovable Property (Real Property)), and (b) an interest in a partnership or trust to the extent that the assets of that partnership or trust consist of immovable property (real property) situated in Bulgaria or shares described in (3)(a). Under U.S. internal law, a U.S. real property interest includes, among other property, shares in a U.S. corporation that owns sufficient U.S. real property interests to satisfy an asset-based test.

As provided in the proposed 2007 protocol, an established securities market means a national securities exchange that is officially recognized, sanctioned, or supervised by a governmental authority and any market reflected by the existence of an interdealer quotation system. An interdealer quotation system is any system of general circulation to brokers and dealers that regularly disseminates quotations of stocks and securities by identified brokers or dealers, other than by quotation sheets that are prepared and distributed by a broker or dealer in the regular course of business and that contain only quotations of such broker or dealer.

The proposed treaty includes a standard provision that permits a treaty country to tax gains from the alienation of movable property (that is, property other than immovable property (real property)) that forms a part of the business property of a permanent establishment that an enterprise of the other treaty country has in the first treaty country. This rule permits source-country taxation of gains from the alienation of the permanent establishment (alone or with the

enterprise as a whole). According to the Technical Explanation, this taxation is permitted whether or not the permanent establishment exists at the time of alienation. Consequently, income that is attributable to a permanent establishment, but that is deferred and is received after the permanent establishment no longer exists, may nevertheless be taxed in the treaty country in which the permanent establishment was located. This rule is similar to a rule in U.S. internal law.

The Technical Explanation notes that a resident of Bulgaria that is a partner in a partnership doing business in the United States generally will have a permanent establishment in the United States as a result of the activities of the partnership. Under the proposed treaty, the United States may tax the partner's distributive share of income realized by the partnership on the disposition of movable property forming part of the partnership's business property in the United States.

The proposed treaty provides that gains derived by an enterprise of one treaty country from the alienation of ships or aircraft operated or used in international traffic, or of movable property related to the operation or use of the ships or aircraft, are taxable only in that country. This rule applies even if the gains are attributable to a permanent establishment maintained by the enterprise in the other treaty country.

Similarly, gains derived by an enterprise of a treaty country from the alienation of containers (including trailers and related equipment for the transport of containers) used for the transport of goods or merchandise are taxable only in that country, unless those containers or trailers and related equipment are used for transport solely between places in the other treaty country. The general rule of exclusive residence country taxation applies even if the gains are attributable to a permanent establishment in the other treaty country.

The proposed treaty includes a special rule that permits one treaty country to tax gains derived by a resident of the other treaty country from the alienation of shares of a company resident in the first country in certain limited cases. The first requirement for this rule to apply is that the alienation of the shares must occur within 12 months of the date that such shares are acquired. The second requirement is that the recipient of the gain had a participation, directly or indirectly, of at least 25 percent in the capital of that company at any time during the 12-month period preceding the alienation. Finally, the rule does not apply with respect to the alienation of shares of stock of public companies traded on an established securities market. This rule is reciprocal, although currently only Bulgaria imposes a tax to which it will apply.

Gains described as "royalties" in paragraph 3 of Article 12 (Royalties) are taxable only in accordance with the provisions of Article 12 (Royalties).

Gain from the alienation of any property other than the property described above is taxable under the proposed treaty only in the country in which the person alienating the property is a resident.

The Technical Explanation states that the saving clause of paragraph 4 of Article 1 (General Scope) permits the United States to tax its citizens and residents as if the proposed treaty had not come into effect. The Technical Explanation also notes that the benefits of this

Article 13 are available only to a treaty country resident that satisfies one of the conditions in Article 21 (Limitation on Benefits).

Article 14. Income from Employment

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

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

The Technical Explanation to the proposed treaty provides that this article applies to compensation of any type, including payments in kind and income from stock options. Further, it applies without regard to the timing of the payment. Thus, a bonus paid to a resident of a treaty country with respect to services provided in the other treaty country would be subject to the terms of Article 14 (Income from Employment), even if the bonus is paid in a subsequent year.

This article is subject to the provisions of the separate articles covering directors' fees (Article 15), pensions, social security, annuities, alimony, and child support payments (Article 17) and government service (Article 18).

Article 15. Directors' Fees

Under the proposed treaty, directors' fees and other similar payments derived by a resident of one treaty country for services rendered in his or her capacity as a member of the board of directors of a company that is a resident of the other treaty country is taxable in that other country. Under the proposed treaty, it is not relevant where the director performs such services.

Article 16. Entertainers and Sportsmen

Article 16 of the proposed treaty deals with the taxation in a treaty country of entertainers and sportsmen resident in the other treaty country from the performance of their services as such. The Technical Explanation states that Article 16 applies both to the income of an entertainer or sportsman who performs services on his own behalf and one who performs services on behalf of

another person, either as an employee of that person, or pursuant to any other arrangement. The rules of this article take precedence, in some circumstances, over those of Articles 7 (Business Profits) and 14 (Income from Employment).

In general

Paragraph 1 describes the circumstances in which a treaty country may tax the performance income of an entertainer or sportsman who is a resident of the other treaty country. Under the paragraph, income derived by an individual resident of a treaty country from activities as an entertainer or sportsman exercised in the other treaty country may be taxed in that other country if the amount of the gross receipts derived by the performer exceeds \$15,000 (or its equivalent in Bulgarian currency) for the taxable year. The Treasury Explanation states that the determination as to whether the \$15,000 threshold has been exceeded is determined separately with respect to each year of payment.

According to the Technical Explanation, the monetary threshold is designed to reach entertainers and athletes who are paid relatively large sums of money for very short periods of service, and who would, therefore, normally be exempt from host-country tax under the standard personal services income rules. The monetary threshold in the proposed treaty is lower than the \$20,000 monetary threshold in the U.S. Model treaty.

Tax may be imposed under paragraph 1 even if the performer would have been exempt from tax under Article 7 or 14. On the other hand, if the performer would be exempt from host-country tax under Article 16, but would be taxable under either Article 7 or 14, tax may be imposed under either of those Articles. For example, a performer who receives less than the \$15,000 threshold amount and therefore is not taxable under Article 16 nevertheless may be subject to tax in the host country under Article 7 or 14 if the tests for host-country taxability under the relevant article are met.

The Technical Explanation points out that nothing in Article 16 precludes a treaty country from withholding tax from payments during the year and refunding it after the close of the year if the monetary threshold has not been met.

The Technical Explanation states that Article 16 applies to all income connected with a performance by the entertainer, such as appearance fees, award or prize money, and a share of the gate receipts. Income derived from a treaty country by a performer who is a resident of the other treaty country from other than actual performance, such as royalties from record sales and payments for product endorsements, is not covered by Article 16, but by other articles of the treaty, such as Article 12 (Royalties) or Article 7. The Technical Explanation states that in determining whether income falls under Article 16 or another article, the controlling factor will be whether the income in question is predominantly attributable to the performance itself or to other activities or property rights.

According to the Technical Explanation, where an individual fulfills a dual role as performer and non-performer (such as a player-coach or an actor-director), but his role in one of the two capacities is negligible, the predominant character of the individual's activities should

control the characterization of those activities. In other cases, there should be an apportionment between the performance-related compensation and other compensation.

Income accrues to another person

The Technical Explanation states that paragraph 2 of Article 16 is intended to address the potential for circumvention of the rule in paragraph 1 when a performer's income does not accrue directly to the performer himself, but to another person.

For example, the “employer” may be a company established and owned by the performer, which is merely acting as the nominal income recipient in respect of the remuneration for the performance (a “star company”). The performer may act as an “employee,” receive a modest salary, and arrange to receive the remainder of the income from his performance from the company in another form or at a later time. In such case, absent the provisions of paragraph 2, the income arguably could escape host-country tax because the company earns business profits but has no permanent establishment in that country. The performer may largely or entirely escape host-country tax by receiving only a small salary, perhaps small enough to place him below the monetary threshold in paragraph 1.

Paragraph 2 seeks to prevent this result. Under paragraph 2, when the income accrues to a person other than the performer, the income may be taxed in the treaty country where the performer’s services are exercised, without regard to the provisions of the proposed treaty concerning business profits (Article 7) or income from employment (Article 14), if one of two conditions is met. The first condition is that the contract pursuant to which the personal activities are performed designates the entertainer or sportsman (by name or description). The second condition is that the contract allows the other party to the contract (or a person other than the entertainer, sportsman, or the person to whom the income accrues) to designate the individual who is to perform the personal activities.

According to the Technical Explanation, the premise of the conditions is that, in a case where a performer is using another person in an attempt to circumvent the provisions of paragraph 1, the recipient of the services of the performer would contract with a person other than that performer (i.e., a company employing the performer) only if the recipient of the services were certain that the performer himself would perform the services (i.e., the contract mentioned the performer by name or description or else allowed the recipient of the services to designate who is to perform the services). If instead the person to whom the income accrues is allowed to designate the individual who is to perform the services, then it is likely that the person is a service company not formed to circumvent the provisions of paragraph 1.

Taxation under paragraph 2 is on the person providing the services of the performer. Paragraph 2 does not affect the rules of paragraph 1, which apply to the performer himself. According to the Technical Explanation, the income taxable by virtue of paragraph 2 is reduced to the extent of salary payments to the performer, which fall under paragraph 1.

Relationship to other articles

Article 16 is subject to the provisions of the saving clause of paragraph 4 of Article 1 (General Scope). Thus, if an entertainer or a sportsman who is resident in Bulgaria is a citizen of

the United States, the United States may tax all of his income from performances in the United States without regard to the provisions of Article 16, subject to the foreign tax credit provisions of Article 22 (Relief From Double Taxation). In addition, the benefits of this article are subject to the provisions of Article 21 (Limitation on Benefits).

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

This article deals with the taxation of private pensions, social security benefits, annuities, and, to a limited extent, pension funds, as defined in Article 3(m). This article does not cover payments of government pensions covered under Article 18 (Government Service).

Pension distributions

The proposed treaty includes the provision of the U.S. Model treaty under which pensions and other similar remuneration beneficially owned by a resident of a treaty country is taxable only in that country. The proposed treaty does not include the provision of the U.S. Model treaty that precludes the individual's country of residence from taxing the portion of pension income arising in the other country that would have been exempt in the source country if the beneficiary were a resident there. Consequently, Bulgaria may tax according to its internal tax law a distribution of a Roth IRA to a resident of Bulgaria. The proposed treaty also does not include the provisions of the U.S. Model treaty that address cross-border contributions to pension funds.

According to the Technical Explanation, the term "pensions and other similar remuneration" includes both periodic and lump sum payments and is intended to encompass payments made by qualified private retirement plans. According to the Technical Explanation, in the United States, the plans encompassed by "pensions and other similar remuneration" include: qualified plans under section 401(a), individual retirement plans (including individual retirement plans that are part of a simplified employee pension plan that satisfies section 408(k), individual retirement accounts and section 408(p) accounts), section 403(a) qualified annuity plans, and section 403(b) plans. Distributions from section 457 plans may also meet this definition if they are not paid with respect to government services covered by Article 18.

Pensions in respect of government services covered by Article 18 are not covered by the term "pensions and other similar remuneration." Such pensions are covered either by paragraph 2 of this article, if they are in the form of social security benefits, or by paragraph 2 of Article 18.

Timing of pension income and pension funds

The proposed treaty provides that neither country may tax a resident of a treaty country on pension income earned through a pension fund that is a resident of the other country until such income is distributed. When a resident receives a distribution from a pension fund, such distribution is subject to taxation in accordance with the provisions of this article (or if relevant, Article 18). For example, if a U.S. citizen contributes to a U.S. qualified plan while working in the United States and then establishes residence in Bulgaria, Bulgaria is prevented from taxing currently that pension plan's earnings and accretions with respect to that individual. Like the U.S. Model treaty, the proposed treaty exempts same-country "rollover" distributions (i.e., from a pension fund in the other treaty country to a pension fund in that country). Therefore, for

example, a rollover distribution from a U.S. pension fund to another U.S. pension fund is not treated as a distribution to a Bulgarian resident beneficiary of that fund.

The term “pension fund” is defined in paragraph 1(m) of Article 3 (General Definitions) and means any person established in a treaty country that (1) is generally exempt from income taxation in that country, and (2) operates principally to administer or provide pension or retirement benefits or to earn income for the benefit of one or more such arrangements. This definition is discussed in the description of Article 3.

Social security benefits

The proposed treaty, like the U.S. Model treaty, provides for exclusive source-country taxation of payments made under provisions of social security or “similar legislation.” This provision is an exception to the saving clause of paragraph 4 of Article 1 (General Scope) by virtue of subparagraph 5(a) of Article 1. Thus, only Bulgaria and not the United States may tax Bulgarian social security benefits paid to a U.S. citizen. The provision under the proposed treaty applies to both private sector and government employees. The term “similar legislation” is intended to refer to United States tier 1 Railroad Retirement benefits.

Annuities

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

Alimony and child support

Under the proposed treaty, alimony and child support payments paid by a resident of a treaty country to a resident of the other treaty country are taxable only in the payor’s country. However, such payments are not taxable in either treaty country if the payor is not entitled to an income tax deduction for such payments in the payor’s residence country. The term “alimony” means periodic payments made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support. Under the U.S. Model treaty, alimony is taxable only in the residence state and child support is exempt from tax in both treaty countries.

Saving clause

Paragraphs 1, 3, and 4 of Article 17 are subject to the saving clause of paragraph 4 of Article 1 (General Scope). Thus, a U.S. citizen who is a resident of Bulgaria, and receives a pension, annuity, or alimony payment from the United States, may be subject to U.S. tax on the payment, notwithstanding the rules in paragraphs 1, 3, and 4. Paragraphs 2 and 5 are excepted from the saving clause by virtue of subparagraph 5(a) of Article 1. Thus, the United States will

not tax U.S. citizens and residents on the income described in paragraph 2, even if such amounts otherwise would be subject to tax under U.S. law, and the United States will allow U.S. citizens and residents the benefits of paragraph 5.

Article 18. Government Service

Under paragraph 1 of Article 18 of the proposed treaty, remuneration, other than a pension, paid to an individual for services rendered to a treaty country (or political subdivision or local authority) is taxable only in that country. However, the remuneration is taxable only in the other country if the services are rendered there and the individual is a resident of that other country who is either a national of that other country or who did not become a resident of that other country solely for the purpose of rendering the services. According to the Technical Explanation, the provision applies to anyone performing services for a government, whether as an employee, an independent contractor, or an employee of an independent contractor.

Paragraph 2 covers any pension paid by, or out of funds created by, a treaty country that is not in the form of social security benefits and is in respect of government service rendered to a treaty country (or subdivision or authority) by an individual. Such a pension is taxable only in that country. However, such a pension is taxable only in the other country if the individual is both a resident and a national of the other country. According to the Technical Explanation, pensions paid to retired civilian and military employees of the government of either country are intended to be covered under paragraph 2.

When benefits paid by a treaty country in respect of services rendered to that country (or subdivision or authority) are in the form of social security benefits, those payments are covered by paragraph 2 of Article 17 (Pensions, Social Security Payments, Annuities, Alimony, and Child Support). As a general matter, the result will be the same whether Article 17 or 18 applies, since both social security benefits and government pensions are taxable exclusively by the source country. According to the Technical Explanation, the result differs only when the payment is made to a citizen and resident of the other country, who is not also a citizen of the paying country. In such a case, social security benefits continue to be taxable at source while government pensions are taxable only in the residence country.

The treatment of payments described in paragraphs 1 and 2 of this article are subject to the provisions of those paragraphs and not to those of Articles 14 (Income from Employment), 15 (Directors' Fees), 16 (Entertainers and Sportsmen) or, except as noted above for social security payments, 17 (Pensions, Social Security, Annuities, Alimony, and Child Support). If, however, the remuneration or pension is paid for services performed in connection with a business carried on by a treaty country (or subdivision or authority), those other articles, and not Article 18, apply.

Under subparagraph 5(b) of Article 1 (General Scope), the saving clause (paragraph 4 of Article 1) does not apply to the benefits conferred by one of the treaty countries under Article 18 if the recipient of the benefits is neither a citizen of that State, nor a person who has been admitted for permanent residence (i.e., in the United States, a "green card" holder). As an example, the Technical Explanation states that a resident of a treaty country who in the course of performing functions of a governmental nature for that country becomes a resident of the other

country (but not a permanent resident), would be entitled to the benefits of Article 18. The Technical Explanations states that, similarly, an individual who receives a pension paid by the Government of Bulgaria in respect of services rendered to the Government of Bulgaria shall be taxable on this pension only in Bulgaria unless the individual is a U.S. citizen or acquires a U.S. green card.

Article 19. Students, Trainees, Teachers and Researchers

Students and business trainees

The treatment provided to students and business trainees under the proposed treaty generally corresponds to the provision in the U.S. Model treaty, with certain modifications, and is similar to the provision of the OECD Model treaty.

Under the proposed treaty, a student or business trainee who visits a treaty country (“host country”) and who is, or was immediately prior to visiting the host country, a resident of the other treaty country will be exempt from income tax in the host country on certain payments received if the purpose of the visit is to engage in full-time training or full-time education at a college, university, or other recognized educational institution. The exempt payments are limited to those payments the individual may receive for his or her maintenance, education, or training as long as such payments are from sources outside the host country. In the case of business trainees, the exemption from income tax in the host country applies only for a period of two years from the time the visitor first arrives in the host country for training.

The proposed treaty also provides students and business trainees with an exemption for income from personal services performed in the host country up to a total of \$9,000 U.S. dollars or its equivalent in Bulgarian currency annually. This amount will be adjusted every five years.

As similarly defined in the U.S. Model treaty, a business trainee is an individual who is in the host country temporarily either (1) for the purpose of securing training required to qualify the individual to practice a profession or professional specialty or (2) as an employee of, or under contract with, a resident of the other treaty country for the primary purpose of acquiring technical, professional, or business experience from a person other than that resident or a person related to such resident.

The Technical Explanation points out that that the saving clause of Article 1 of the proposed treaty does not apply under this Article in the case of an individual who is neither a citizen of the host country nor admitted to permanent residence in the host country (i.e., in the United States, the individual does not acquire a green card). Such an individual is entitled to the exemptions under this Article. The saving clause does, however, apply to citizens and permanent residents of the host country. As an example, the Technical Explanation refers to a U.S. citizen who is a resident of Bulgaria and who visits the United States as a full time student; such an individual is not eligible for the exemption under this Article from U.S. tax on remittances from abroad that otherwise constitute U.S. taxable income.

Teachers and researchers

The treatment provided to teachers and researchers under the proposed treaty is not part of either the U.S. Model treaty or the OECD Model treaty.

Under the proposed treaty, an individual who visits a host country for the purpose of teaching or engaging in research at a school, university, college, or other recognized educational or research institution, and who at the beginning of that visit is a resident of the other treaty country, generally is exempt from tax in the host country on the remuneration received in consideration of teaching or carrying on research. However, income from research undertaken not in the public interest but primarily for the benefit of a specific person or persons is not tax exempt. The exemption applies only for a period of two years from the time the visitor first arrives in the host country.

Article 20. Other Income

Article 20 assigns taxing jurisdiction over items of income beneficially owned by a resident of a contracting state and not dealt with in the other articles of the proposed treaty. The general rule is that such items are taxable only in the country of residence. This rule is similar to the rules in the U.S. and OECD Model treaties.

In order for an item of income to be "dealt with" in another article it must be the type of income described in the article and, in most cases, it must have its source in one of the treaty countries. For example, royalty income that is beneficially owned by a resident of a treaty country is "dealt with" in Article 12 (Royalties) if the royalty income arises in the other treaty country, but not if the royalty income arises in a third country. However, profits derived in the conduct of a business are "dealt with" in Article 7 (Business Profits) whether or not they have their source in one of the treaty countries.

According to the Technical Explanation, examples of types of items of income covered by Article 20 include income from gambling, punitive (but not compensatory) damages, and covenants not to compete. Article 20 also applies to income from a variety of financial transactions in cases where such income does not arise in the course of the conduct of a trade or business.

Distributions from partnerships are not generally dealt with under Article 20 because partnership distributions generally do not constitute income. Under the Code, partners include in income annually their distributive share of partnership income, and partnership distributions themselves generally do not give rise to income. This would also be the case under U.S. law with respect to distributions from trusts. Trust income and distributions that, under the Code, have the character of the associated distributable net income would generally be covered by another article of the proposed treaty.

The general rule of residence taxation does not apply to income (other than income from immovable property (real property) as defined in paragraph 2 of Article 6) if the beneficial owner of the income is a resident of one country and carries on a business in the other country through a permanent establishment situated therein, and the income is attributable to such

permanent establishment. In such a case, the provisions of Article 7 (Business Profits) will apply.

This article is subject to the saving clause in paragraph 4 of Article 1 (General Scope). Accordingly, U.S. citizens who are residents of Bulgaria will continue to be taxable by the United States on income to which this article applies, including relevant third-country income. The article is also subject to the provisions of Article 21 (Limitation on Benefits). Thus, if a resident of Bulgaria earns income that falls within the scope of paragraph 1 of Article 20, but that is taxable by the United States under U.S. law, the income would be exempt from U.S. tax under the provisions of Article 20 only if the resident satisfies one of the tests of Article 21 for entitlement to benefits.

Article 21. Limitation on Benefits

In general

Article 21 of the proposed treaty includes rules that are similar to the limitation-on-benefits provisions included in other recent U.S. income tax treaties and protocols. These rules are intended to prevent the indirect use of the treaty by persons who are not entitled to its benefits by reason of residence in Bulgaria or the United States.

The proposed treaty is intended to limit double taxation caused by the interaction of the tax systems of the United States and Bulgaria as they apply to residents of the two countries. At times, however, residents of third countries attempt to benefit from a treaty by engaging in treaty shopping. Treaty shopping by a third-country resident may involve organizing, in a treaty country, a corporation that is entitled to the benefits of the treaty. Alternatively, a third-country resident eligible for favorable treatment under the tax rules of its country of residency may attempt to reduce the income base of a treaty country resident by having that treaty country resident pay to it, directly or indirectly, interest, royalties, or other amounts that are deductible in the treaty country from which the payments are made. Limitation-on-benefits provisions are intended to deny treaty benefits in certain cases of treaty shopping or income stripping engaged in by third-country residents.

Generally, a resident of either treaty country is entitled to all the benefits accorded by the proposed treaty if the resident has any one of six listed attributes. The six attributes are that the resident is: (1) an individual; (2) one of the two treaty countries or a political subdivision or local authority of one of the two countries; (3) a company that satisfies a public company test or that is a subsidiary of a public company; (4) a pension fund that satisfies a beneficiaries test; (5) an organization that is established and maintained in its country of residence exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes, even if all or part of its income or gains are exempt from tax under the residence country's domestic law; or (6) an entity that satisfies an ownership test and a base erosion test. A resident that has none of these six attributes may be entitled to treaty benefits with respect to certain items of income under the derivative benefits test or the active business test.

Special anti-abuse rules govern certain items of income derived from the United States by an enterprise resident in Bulgaria in so-called "triangular cases."

A person that does not satisfy any of the requirements described above may be entitled to the benefits of the treaty if the source country's competent authority so determines.

Six attributes for qualification for all treaty benefits

Individual

Under the proposed treaty, an individual resident of the United States or Bulgaria is entitled to all treaty benefits. If, however, such an individual receives income as a nominee on behalf of a third-country resident, and thus is not the beneficial owner of the income, benefits may be denied.

Governments

The proposed treaty provides that the United States and Bulgaria, and any political subdivision or local authority of either of the two countries, are entitled to all treaty benefits.

Publicly traded companies and subsidiaries

A company that is a resident of the United States or Bulgaria is entitled to all treaty benefits if the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognized stock exchanges (the "regular trading test") and either (1) the company's principal class of shares is primarily traded on one or more recognized stock exchanges in its country of residence (the "primary trading test"), or (2) the company's primary place of management and control is in its country of residence (the "management and control test"). Certain key elements of the regular trading test, primary trading test, and management and control test are described below.

The term "principal class of shares" means the ordinary or common shares of a company representing the majority of the aggregate voting power and value of that company. If the company does not have a single class of ordinary or common shares representing the majority of the aggregate voting power and value, then the "principal class of shares" means that class or those classes of shares that in the aggregate represent a majority of the aggregate voting power and value of the company.

A company that is resident in one treaty country has a "disproportionate class of shares" if any outstanding class of shares is subject to terms or other arrangements that entitle a shareholder to a larger portion of the company's income, profit, or gain in the other treaty country than that to which the shareholder would be entitled in the absence of those terms or arrangements. For example, the Technical Explanation states that a company resident in Bulgaria meets this test if it has outstanding a class of tracking stock that pays dividends based upon a formula that approximates the company's return on its assets employed in the United States.

A class of shares is considered to be "regularly traded" in a taxable year if the aggregate number of shares of that class traded on one or more recognized stock exchanges during the preceding taxable year is at least six percent of the average number of shares outstanding in that class during that preceding taxable year. The Technical Explanation notes that trading on one or

more recognized stock exchanges may be aggregated for purposes of meeting the “regularly traded” requirement.

The term “recognized stock exchange” means the NASDAQ System owned by the National Association of Securities Dealers, Inc.; any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934; the Bulgarian Stock Exchange - Sofia; any other stock exchange licensed to trade securities and financial instruments under Bulgarian law; and any other stock exchange agreed upon by the competent authorities of the treaty countries.

The term “primarily traded” is not defined in the proposed treaty and therefore has the meaning it has under the laws of the relevant treaty country, usually the source country. In the United States, the term has the same meaning as it does under Treas. Reg. section 1.884-5(d)(3). Based on that provision, the Technical Explanation states that stock of a corporation is primarily traded in the company’s country of residence if the number of shares in the company’s principal class of shares that are traded during the taxable year on all recognized stock exchanges in the treaty country of which the company is a resident exceeds the number of shares in the company’s principal class of shares that are traded during that year on established securities markets in any other single foreign country.

A company the principal class of shares (and any disproportionate class of shares) of which is regularly traded on a recognized stock exchange but which does not satisfy the primary trading test (that is, the requirement that a company’s principal class of shares be primarily traded on a recognized stock exchange) may claim treaty benefits if it satisfies the management and control test—that is, if the company’s primary place of management and control is in the treaty country of which it is a resident. A company’s primary place of management is located in the treaty country in which the company is a resident only if the executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial, and operational policy decision making for the company (including direct and indirect subsidiaries) in that country than in the other treaty country or any third country, and if the staff that support the management in making those decisions are also based in that residence country.

The Technical Explanation notes that the management and control test should be distinguished from the “place of effective management” test used by many countries and in the OECD Model treaty to establish residence. The place of effective management test often has been interpreted to mean the place where the board of directors meets. Under the proposed treaty, by contrast, the management and control test looks to where day-to-day responsibility for the management of the company (and its subsidiaries) is exercised.

A company that does not satisfy the regular trading test and either the primary trading test or the management and control test (because, for example, its shares are not publicly traded) may be entitled to treaty benefits if shares representing at least 50 percent of its aggregate voting power and value (and at least 50 percent of any disproportionate class of its shares) are owned, directly or indirectly, by five or fewer companies that satisfy the regular trading test and either the primary trading test or the management and control test, provided that, in the case of indirect ownership, each intermediate owner is a resident of the United States or Bulgaria. This rule

allows certain subsidiaries of publicly traded companies to be eligible for all benefits under the treaty.

Pension funds

A pension fund is entitled to all the benefits of the proposed treaty if more than 50 percent of the fund's beneficiaries, members, or participants are individuals resident in either the United States or Bulgaria. According to the Technical Explanation, for purposes of this provision, the term "beneficiaries" should be understood to refer to the persons receiving benefits from the organization.

Tax-exempt organizations

An organization established and maintained in its country of residence exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes is entitled to treaty benefits notwithstanding that all or part of its income or gains may be exempt from tax under the domestic law of that country. The Technical Explanation notes that a tax-exempt organization other than a pension fund qualifies for benefits without regard to the residence of its beneficiaries or members.

Ownership and base erosion tests

An entity that is a resident of one of the treaty countries is entitled to treaty benefits if it satisfies both an ownership test and a base erosion test.

An entity that is a resident of a treaty country satisfies the ownership test if on at least half the days of the taxable year shares or other beneficial interests representing at least 50 percent of the entity's aggregate voting power and value (and at least 50 percent of any disproportionate class of its shares) are owned, directly or indirectly, by residents of that treaty country who are entitled to treaty benefits under the limitation-on-benefits article as individuals, governments, parent companies that meet the public company test, pension funds, or tax-exempt organizations. In the case of indirect ownership, each intermediate owner must be a resident of the same treaty country as the entity seeking to satisfy the ownership test.

The base erosion test is satisfied only if less than 50 percent of the person's gross income for the taxable year, as determined in that person's country of residence, is paid or accrued, directly or indirectly, in the form of payments deductible in the person's country of residence, to persons who are not residents of either treaty country entitled to treaty benefits under this article as individuals, governments, parent companies that meet the public company test, pension funds, or tax-exempt organizations. Arm's-length payments made in the ordinary course of business for services or tangible property do not count against the entity in determining whether the 50-percent threshold is reached.

The Technical Explanation states that trusts may be entitled to the benefits of this provision if they are treated as residents under Article 4 (Resident) and they otherwise satisfy the ownership and base erosion tests.

Derivative benefits rule

The proposed treaty includes derivative benefits rules that are generally intended to allow a treaty-country company treaty benefits for an item of income if the company's owners would have been entitled to the same benefits for the income had those owners derived the income directly. Under these derivative benefits rules, a treaty-country company is eligible for treaty benefits for an item of income only if the company satisfies both an ownership requirement and a base erosion requirement.

A company satisfies the ownership requirement if shares representing at least 95 percent of the company's aggregate voting power and value, and at least 50 percent of any of the company's disproportionate class of shares, are owned directly or indirectly by seven or fewer persons who are equivalent beneficiaries. The term "disproportionate class of shares" has the same definition as the definition previously described.

A company satisfies the base erosion requirement for an item of income only if, in the taxable year in which the income item arises, the amount of the deductible payments or accruals the company makes, directly or indirectly, to persons who are not equivalent beneficiaries is less than 50 percent of the company's gross income for the year, as determined in the company's country of residence. Deductible payments do not include arm's-length payments in the ordinary course of a business for services or tangible property. The Technical Explanation notes that the base erosion requirement under the derivative benefits rule is the same as the base erosion test described previously (that is, the test that is included in the rules for determining whether a treaty country resident has one of the six attributes for qualification for all treaty benefits), except that, for the derivative benefits rule, deductible payments made to equivalent beneficiaries, not just to residents of a treaty country entitled to treaty benefits, are excluded from the payments that count toward the 50-percent limitation.

An equivalent beneficiary must be a resident of a European Union member state, a European Economic Area state, or a North American Free Trade Agreement party (together, "qualifying countries") and must satisfy either of two criteria described below.

The first criterion includes two requirements. First, the person must be entitled to all treaty benefits under a comprehensive income tax treaty between a qualifying country and the country from which the benefits of the proposed treaty are being claimed (an "applicable treaty"), and this entitlement to treaty benefits must result from satisfaction of limitation-on-benefits provisions analogous to the proposed treaty's rules, described above, for individuals, governments, parent companies that meet the public company test, pension funds, and tax-exempt organizations. If the applicable treaty does not include a comprehensive limitation-on-benefits article, this first requirement is satisfied only if the person would meet the proposed treaty's requirements for entitlement to treaty benefits as an individual, a government, a parent company that meets the public company test, a tax-exempt organization, or a pension fund. Second, for income from dividends, interest, or royalties, the person must be entitled under an applicable treaty to a rate of tax on that income that is at least as low as the rate applicable under the proposed treaty (the "tax rate test").

For dividend, interest, or royalty payments arising in Bulgaria and beneficially owned by a resident of the United States, the proposed treaty includes a special rule for determining whether a company that is a resident of an EU member state satisfies the tax rate test for purposes of determining whether the U.S. resident is entitled to treaty benefits for the payments. The special rule provides that the EU member state resident satisfies the tax rate test if a dividend, interest, or royalty payment arising in Bulgaria and paid directly to that EU member state resident would be exempt from withholding tax under an EU directive even though the income tax treaty between Bulgaria and that EU member state would permit imposition of a higher withholding tax rate on that payment than is permitted by the proposed treaty. The Technical Explanation states that this special rule takes account of the fact that withholding taxes on many intercompany dividend, interest, and royalty payments are exempt within the EU under various EU directives. The special rule is necessary, according to the Technical Explanation, because many EU member countries have not renegotiated their tax treaties to reflect the EU directives' elimination of withholding tax.

Under the second criterion for determining whether a resident of a qualifying country is an equivalent beneficiary, the resident must be a U.S. or Bulgarian resident that is entitled to treaty benefits under one of the rules described previously for individuals, governments, parent companies that meet the public company test, pension funds, and tax-exempt organizations. Under this rule, according to the Technical Explanation, a Bulgarian individual is an equivalent beneficiary for an item of income received by another treaty country resident regardless of whether the individual would have been entitled to receive the same benefits if it had received the income directly. The Technical Explanation states that this criterion was included to clarify that ownership by certain residents of a treaty country does not disqualify a U.S. or Bulgarian company from treaty benefits under the derivative benefits rules. If, for example, 90 percent of a Bulgarian company is owned by five companies that are residents of EU member states and that satisfy the first criterion described previously (the applicable treaty rules and the tax rate test), and 10 percent of the Bulgarian company is owned by a U.S. or a Bulgarian individual, the Bulgarian company still can satisfy the requirements of the ownership test of the derivative benefits rules.

Active business test

Under the proposed treaty, a resident of one treaty country is entitled to treaty benefits with respect to an item of income derived from the other country if (1) the resident is engaged in the active conduct of a trade or business in its residence country, and (2) the income from the other country is derived in connection with or is incidental to that trade or business. The proposed treaty provides that the business of making or managing investments for the resident's own account does not constitute an active trade or business unless the business is banking, insurance, or securities activities carried on by a bank, an insurance company, or a registered securities dealer.

The term "trade or business" is not defined in the proposed treaty. According to the Technical Explanation, under paragraph 2 of Article 3 (General Definitions) of the proposed treaty, when determining whether a resident of Bulgaria is entitled to the benefits of the proposed treaty under the active business test with respect to an item of income derived from sources within the United States, the United States will ascribe to this term the meaning that it has under

the laws of the United States. Accordingly, the Technical Explanation states, the U.S. competent authority will refer to the regulations issued under section 367(a) for the definition of the term “trade or business.” In general, a trade or business will be considered to be a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit. Furthermore, a corporation generally will be considered to carry on a trade or business only if the officers and employees of the corporation conduct substantial managerial and operational activities.

The Technical Explanation elaborates on the requirement that an item of income from the source country be derived “in connection with” or be “incidental to” the resident’s trade or business in its residence country. The Technical Explanation provides that an item of income is derived in connection with a trade or business if the income-producing activity in the source country is a line of business that “forms a part of” or is “complementary to” the trade or business conducted in the residence country by the income recipient.

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

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

The Technical Explanation further states that an item of income derived from the country of source is “incidental to” the trade or business carried on in the country of residence if production of the item facilitates the conduct of the trade or business in the country of residence. An example of incidental income is the temporary investment of working capital of a person in the country of residence in securities issued by persons in the country of source.

The proposed treaty provides that if a resident of a treaty country or any of its associated enterprises carries on a trade or business activity in the other country that gives rise to an item of income, the active business test applies to the item of income only if the trade or business

activity in the residence country is substantial in relation to the trade or business activity in the source country. The determination is made separately for each item of income derived from the source country.

The Technical Explanation explains that the substantiality requirement is intended to prevent a narrow case of treaty-shopping abuses in which a company attempts to qualify for benefits by engaging in de minimis connected business activities in the treaty country in which it is resident (that is, activities that have little economic cost or effect with respect to the company business as a whole). The determination of substantiality is made based upon all the facts and circumstances and takes into account the comparative sizes of the trades or businesses in each treaty country, the nature of the activities performed in each country, and the relative contributions made to that trade or business in each country.

The proposed treaty provides that, in determining whether a person is engaged in the active conduct of a trade or business in a treaty country, activities conducted by persons “connected” to that first person are deemed to be conducted by that first person. A person is “connected” to another person if one possesses at least 50 percent of the beneficial interest in the other (or, in the case of a company, at least 50 percent of the aggregate voting power and at least 50 percent of the aggregate value of the shares in the company or of the beneficial equity interest in the company), or another person possesses, directly or indirectly, that requisite interest in each of the two entities. A person is also considered to be connected to another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.

The triangular case

The proposed treaty provides a special anti-abuse rule that, according to the Technical Explanation, addresses a Bulgarian resident’s use of the following structure to earn interest income from the United States. The Bulgarian resident (who is otherwise qualified for benefits under this article) organizes a permanent establishment in a third country that imposes a low rate of tax on the income of the permanent establishment. The Bulgarian resident then lends funds into the United States through the permanent establishment. The permanent establishment is an integral part of the Bulgarian resident. Consequently, the interest income that the permanent establishment earns on the loan is entitled to exemption from U.S. withholding tax under the treaty. Under the tax treaty between Bulgaria and the third country, Bulgaria does not tax the income earned by the permanent establishment. Alternatively, Bulgaria may choose to exempt the income of the permanent establishment from Bulgarian income tax. Consequently, the income is not taxed in Bulgaria or the United States, and is only lightly taxed in the third country.

Under the proposed treaty, the United States may impose withholding tax on the interest payments if the tax actually paid on the income in the third country is less than 60 percent of the tax that would have been payable to Bulgaria if the income were earned in Bulgaria and were not attributable to the permanent establishment in the third country.

Although the example in the Technical Explanation involves interest income, the triangular provision also applies to royalties. Any interest or royalties to which the provision applies may be subject to a maximum withholding tax rate of 15 percent.

According to the Technical Explanation, the principles of the U.S. subpart F rules are employed to determine whether the profits of the permanent establishment are subject to an effective rate of tax that is above the specified threshold.

The triangular provision does not apply to a person's interest income derived from the United States if the income is derived in connection with, or is incidental to, the active conduct of a trade or business carried on by the permanent establishment in the third country (other than the business of making, managing, or holding investments for the person's own account, unless the business is banking or securities activities carried on by a bank or a registered securities dealer). The triangular provision does not apply to royalties that are received as compensation for the use of, or the right to use, intangible property produced or developed by the permanent establishment itself.

Grant of treaty benefits by the competent authority

Under the proposed treaty, a resident of a treaty country that is not otherwise entitled to treaty benefits under this article may nonetheless be granted treaty benefits if the competent authority of the other treaty country determines that the establishment, acquisition, or maintenance of the resident and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the treaty.

According to the Technical Explanation, the competent authority's discretion under this provision is broad. The competent authority, for example, may grant all treaty benefits, may grant benefits only with respect to a particular item of income, and may set time limits on the duration of any relief granted.

Article 22. Relief From Double Taxation

Internal taxation rules

United States

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

A fundamental premise of the foreign tax credit is that it may not offset U.S. tax on U.S.-source income. Therefore, the foreign tax credit provisions contain a limitation that is intended

to prevent the foreign tax credit from offsetting U.S. tax on foreign-source income. The limitation is calculated by multiplying a taxpayer's total U.S. tax liability by the ratio of the taxpayer's foreign-source income to its total income. The foreign tax credit limitation generally is computed on a worldwide basis. Hence, foreign-source income from all foreign countries generally is combined for purposes of determining the limitation. The limitation is computed separately for "passive category income" and all other income in order to prevent the crediting of foreign taxes imposed on certain high-taxed foreign-source income against the U.S. tax on certain types of traditionally low-taxed foreign-source income. Other limitations may apply in determining the amount of foreign taxes that may be credited against the U.S. tax liability of a U.S. taxpayer.

Bulgaria

Individuals and corporations resident in Bulgaria are taxed on their worldwide income. Individuals in Bulgaria generally are subject to a flat tax of 10 percent on income. The standard corporate tax rate is 10 percent; however, this rate may be reduced or eliminated through a variety of tax incentives.⁵⁰ Other resident entities subject to the corporate tax include partnerships, limited liability companies, joint stock companies, nonprofit organizations, state-financed legal entities, and branches and permanent establishments of nonresident entities.

In the absence of a treaty, relief from double taxation of foreign-source income is provided in the form of a tax credit. The tax credit is limited to the amount of the Bulgarian tax levied on the foreign-source income.

Proposed treaty

Overview

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

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

⁵⁰ IBFD Bulgaria Country Analysis A.2.12.1.

Bulgarian tax relief for U.S. taxes paid

Paragraph 1 of Article 22 provides that Bulgaria will provide relief from double taxation through a mixture of the credit and exemption methods.

Subparagraph 1(a) states the general rule that Bulgaria will exempt income derived by a resident if the income may be taxed in the United States in accordance with the proposed treaty. Subparagraph 1(c) permits Bulgaria to include the income corresponding to the U.S. tax in the resident's tax base in calculating the Bulgarian tax on the remaining income of the resident. Under subparagraph 1(b), Bulgaria provides for a tax credit rather than an exemption with respect to limited classes of income. If the income may be taxed by the United States under the provisions of Article 10 (Dividends), Article 11 (Interest), or Article 12 (Royalties), Bulgaria will relieve double taxation by allowing a credit against Bulgarian tax in an amount equal to the tax paid in the United States on such income, but limited to the amount of Bulgarian tax attributable to such dividend, interest, or royalty income.

U.S. tax relief for Bulgarian taxes paid

Paragraph 2 of Article 22 generally provides that the United States will allow a U.S. citizen or resident a foreign tax credit for the income taxes paid to Bulgaria, and will allow a U.S. corporation a deemed-paid credit when the U.S. corporation receives dividends from a Bulgarian corporation in which the U.S. corporation owns 10 percent or more of the voting stock. The credit generally is to be computed in accordance with the provisions, and subject to the limitations, of U.S. law (as such law may be amended from time to time without changing the general principles of the proposed treaty provisions). This provision is similar to those found in the U.S. Model treaty and many U.S. tax treaties, and is consistent with U.S. law.

The proposed treaty provides that the taxes referred to in paragraphs 3(a)(i), 3(a)(ii) and 4 of Article 2 (Taxes Covered) will be considered income taxes for purposes of paragraph 2. The Technical Explanation states that this rule is based on the Treasury Department's review of Bulgaria's laws.

Paragraph 3 contains a re-sourcing rule that applies for purposes of paragraph 2. Under paragraph 3, an item of gross income (as determined under U.S. law) that is derived by a U.S. resident and that may be taxed by Bulgaria under the proposed treaty will be deemed to be income from sources in Bulgaria for U.S. foreign tax credit purposes. The Technical Explanation states that this re-sourcing rule is intended to ensure that a U.S. resident can obtain an appropriate amount of U.S. foreign tax credit for taxes paid to Bulgaria when the proposed treaty assigns to Bulgaria primary taxing jurisdiction over an item of gross income.

In the case of a U.S.-owned foreign corporation, section 904(g)(10) may apply for purposes of determining the U.S. foreign tax credit allowable with respect to income subject to the re-sourcing rule. Section 904(h)(10) generally applies the foreign tax credit limitation described above separately to re-sourced income. Furthermore, because the re-sourcing rule applies to gross income, not net income, U.S. expense allocation and apportionment rules continue to apply in computing the foreign tax credit limitation.

U.S. citizens who are resident in Bulgaria

Paragraph 4 provides special rules for the tax treatment of certain types of income derived by U.S. citizens who are residents of Bulgaria. U.S. citizens, regardless of residence, are subject to U.S. tax on their worldwide income. The U.S. tax on the income of a U.S. citizen that is resident in Bulgaria may exceed the U.S. tax that may be imposed under the proposed treaty on the income if it were derived by a resident of Bulgaria who is not a U.S. citizen. The Technical Explanation states that the provisions of paragraph 4 ensure that Bulgaria does not bear the cost of U.S. taxation of its citizens who are residents of Bulgaria.

Subparagraph 4(a) provides a special credit rule for Bulgaria that limits the amount of credit Bulgaria must allow a resident of Bulgaria. The rule applies to items of income that would be either exempt from U.S. tax or subject to reduced rates of U.S. tax under the provisions of the proposed treaty if they had been received by a resident of Bulgaria who is not a U.S. citizen. The tax credit allowed by Bulgaria under paragraph 4 with respect to such items need not exceed the U.S. tax that may be imposed under the proposed treaty, other than U.S. tax imposed solely by reason of U.S. citizenship under the provisions of the saving clause of paragraph 4 of Article 1 (General Scope).

For example, if a U.S. citizen resident in Bulgaria receives portfolio dividends from sources within the United States, the foreign tax credit granted by Bulgaria would be limited to 10 percent of the dividend – the U.S. tax that may be imposed under subparagraph 2(b) of Article 10 (Dividends) – even if the shareholder is subject to U.S. net income tax because of his U.S. citizenship.

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

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

Relationship to other Articles

By virtue of subparagraph 5(a) of Article 1 (General Scope), Article 22 is not subject to the saving clause of paragraph 4 of Article 1. Thus, the United States will allow a credit to its citizens and residents in accordance with Article 22, even if such credit were to provide a benefit not available under the Code (such as the re-sourcing provided by paragraph 3 and subparagraph 4(c)).

Article 23. Non-Discrimination

The proposed treaty includes a comprehensive nondiscrimination article. The article is similar to the nondiscrimination article in the U.S. Model and to provisions that have been included in other recent U.S. income tax treaties.

In general, under the proposed treaty, neither treaty country is permitted to discriminate against nationals of the other country by imposing on those nationals more burdensome taxes than it would impose on its own comparably situated nationals in the same circumstances.⁵¹ Not all instances of differential treatment are discriminatory. Differential treatment is permissible in some instances under this rule on the basis of tax-relevant differences (for example, the fact that one person is subject to worldwide taxation in a treaty country and another person is not, or the fact that an item of income may be taxed at a later date in one person's hands but not in another person's hands).

Under the proposed treaty, neither country may tax a permanent establishment of an enterprise of the other country less favorably than it taxes its own enterprises carrying on the same activities.

As under the U.S. and OECD Model treaties, however, a treaty country is not obligated to grant residents of the other treaty country any personal allowances, reliefs, or reductions for tax purposes on account of civil status or family responsibilities that it grants to its own residents.

Except in circumstances in which the anti-avoidance rules described in paragraph 1 of Article 9 (Associated Enterprises), paragraph 7 of Article 11 (Interest), or paragraph 6 of Article 12 (Royalties) apply, interest, royalties, and other disbursements paid by an enterprise of a treaty country to a resident of the other treaty country must be deductible under the same conditions as if those amounts had been paid to a resident of the first treaty country. The Technical Explanation states that the exception relating to paragraph 7 of Article 11 (Interest) would include the denial or deferral of certain interest deductions under section 163(j) of the Code, thus allowing the United States to apply its earnings stripping rules.

Any debts of an enterprise of one treaty country to a resident of the other treaty country must, for purposes of determining the taxable capital of the enterprise, be deductible under the same conditions as if they had been owed to a resident of the first treaty country. According to the Technical Explanation, this rule, which applies in computing capital tax, is consistent with the nondiscrimination provisions generally because those provisions, in contrast with the general purpose of the treaty, which is to cover only income taxes, apply to all taxes levied in either treaty country at all levels of government.

The nondiscrimination rules also apply to enterprises of one treaty country that are owned in whole or in part by one or more residents of the other treaty country. An enterprise of one

⁵¹ A national of one treaty country may claim protection under this article even if the national is not a resident of either treaty country. For example, a U.S. citizen who is resident in a third country is entitled to the same treatment in Bulgaria as a comparably situated Bulgarian national.

treaty country the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other treaty country may not be subjected in the first country to any taxation (or any connected requirement) that is more burdensome than the taxation (or connected requirements) that the first country imposes or may impose on other similar enterprises. As noted above, some differences in treatment may be justified on the basis of tax-relevant differences in circumstances between two enterprises. In this regard, the Technical Explanation provides examples of Code provisions that are understood by the two countries not to violate the nondiscrimination provision of the proposed treaty, including the rules that tax U.S. corporations making certain distributions to foreign shareholders in what would otherwise be nonrecognition transactions, the rules that impose a withholding tax on non-U.S. partners of a partnership, the rules that prevent foreign persons from owning stock in subchapter S corporations, and the rules that prevent foreign corporations from joining in filing consolidated returns with domestic corporations.

The proposed treaty provides that nothing in the nondiscrimination article may be construed as preventing either of the countries from imposing a branch profits tax as described in paragraph 8 of Article 10 (Dividends) or a branch-level interest tax as described in paragraph 9 of Article 11 (Interest).

Notwithstanding the specification of taxes covered by the proposed treaty in Article 2 (Taxes Covered), Article 23 applies to taxes of every kind and description imposed by either country, or any political subdivision or local authority of that treaty country. The Technical Explanation states that customs duties are not regarded as taxes for this purpose.

The saving clause does not apply to the nondiscrimination article. Thus, a U.S. citizen who is a resident of Bulgaria may claim benefits in the United States under Article 23.

Article 24. Mutual Agreement Procedure

The mutual agreement provision permits taxpayers to bring to the attention of the competent authorities problems that may arise under the proposed treaty and authorizes the competent authorities of the two countries to cooperate to resolve disputes, clarify issues, and address cases of double taxation not provided for in the proposed treaty. The saving clause of the proposed treaty does not apply to the mutual agreement procedure. Consequently, the United States may apply to a U.S. citizen or resident rules and definitions agreed to by the competent authorities under the mutual agreement procedure even if those rules and definitions differ from comparable provisions of the Code.

Under Article 24, a person who considers that the actions of one or both of the treaty countries cause that person to be subject to tax in a manner not in accordance with the provisions of the proposed treaty may, irrespective of internal law remedies or time limits for refund claims, present a case to the competent authority of either treaty country. Unlike the OECD Model, the proposed treaty provides no time limit for when a case must be brought. This rule is the same as the rule in the U.S. Model but, according to the Technical Explanation, is more generous than the rule in most U.S. tax treaties. Under most treaties, a taxpayer may bring a case only to the competent authority of the taxpayer's country of residence, citizenship, or nationality. The Technical Explanation notes that the more generous rule of the proposed treaty allows a U.S.

permanent establishment of a corporation that is a resident of Bulgaria to ask the U.S. competent authority for assistance if it is subject to inconsistent treatment in the United States and Bulgaria.

The Technical Explanation notes that typical cases brought under the mutual agreement procedure will involve economic double taxation arising from transfer pricing adjustments but that other types of cases also may be brought. The Technical Explanation gives as an example a taxpayer who has received income that the source country has determined is deferred compensation and therefore is taxable in that country but which the taxpayer believes is a pension taxable only in the taxpayer's country of residence.

The proposed treaty provides that if an objection presented to a competent authority appears to be justified and that competent authority is not itself able to arrive at a satisfactory solution, that competent authority must endeavor to resolve the case by mutual agreement with the competent authority of the other treaty country, with a view to the avoidance of taxation that is not in accordance with the proposed treaty. The proposed treaty provides that any agreement reached will be implemented notwithstanding any time limits or other procedural limitations in the domestic law of either treaty country (for example, a country's applicable statute of limitations). The Technical Explanation notes that if a taxpayer has entered into a closing agreement with the United States before bringing a case to the competent authorities, the U.S. competent authority will do nothing other than endeavor to obtain a correlative adjustment from Bulgaria. Procedural limitations can be overridden, according to the Technical Explanation, only for the purpose of making refunds and not to impose additional tax.

The proposed 2007 protocol provides two rules intended to address questions related to the interaction of the mutual agreement procedure with certain features of Bulgarian law. According to the Technical Explanation, under Bulgarian law a taxpayer may initiate court proceedings before or after it has made a request for assistance under the mutual agreement procedure rules. The first rule in the proposed protocol provides that an agreement reached under the mutual agreement procedure will not affect any court proceedings or any final court decisions or final tax assessment acts unless, in the case of final court decisions or final tax assessment acts, the requirements under Bulgarian law for revision or repeal of final acts are fulfilled. The Technical Explanation notes, however, that under Bulgarian law, an assessment may be changed based on new information and that the Treasury Department understands that Bulgaria will interpret the meaning of "new information" broadly. For example, according to the Technical Explanation, even if an examination in Bulgaria is completed and closed, the Bulgarian competent authority may accept a request for assistance based on new information such as an adjustment in the United States.

The second rule in the proposed 2007 protocol provides that if an examination is completed and closed (and is not pending before a court or has not been settled or decided in court) in a treaty country, that treaty country's competent authority may accept a request for assistance if an adjustment causing double taxation is made in the other treaty country. According to the Technical Explanation, this rule confirms that the Bulgarian competent authority may accept a mutual agreement procedure request based on a U.S.-initiated adjustment and can implement any resulting competent authority agreement so long as the issue that is the subject of the mutual agreement procedure request is not pending before a Bulgarian court and has not been settled or decided in court.

The competent authorities of the treaty countries are to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the proposed treaty. In particular, the competent authorities may agree to: (1) the same attribution of income, deductions, credits, or allowances of an enterprise of one treaty country to the enterprise's permanent establishment situated in the other country; (2) the same allocation of income, deductions, credits, or allowances between persons; (3) the same characterization of particular items of income; (4) the same characterization of persons; (5) the same application of source rules with respect to particular items of income; (6) a common meaning of a term; and (7) advance pricing agreements. The Technical Explanation clarifies that this list is a nonexhaustive list of examples of the kinds of matters about which the competent authorities may reach agreement. The list therefore does not grant any authority that is not otherwise provided by the rule that the competent authorities are to endeavor to resolve by mutual agreement any difficulties or doubts about the interpretation or application of the proposed treaty.

The proposed treaty provides that the competent authorities may consult together for the elimination of double taxation in cases not provided for in the proposed treaty.

The competent authorities may agree to increases in any specific dollar amounts referred to in the proposed treaty to reflect economic or monetary developments. According to the Technical Explanation, this provision refers only to the \$15,000 income exemption from source-country taxation under Article 16 (Entertainers and Sportsmen). The Technical Explanation states that if while the treaty is in force, inflation makes the \$15,000 exemption too low to carry out the objectives of the exemption, the competent authorities may agree to a higher threshold; the proposed treaty will not need to be formally amended by the United States and Bulgaria. This rule cannot be applied to the detriment of taxpayers. Thus, the \$15,000 exemption may not be reduced.

The proposed treaty authorizes the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of this mutual agreement article. The Technical Explanation states that this provision makes clear that the competent authorities may communicate without going through diplomatic channels.

The Technical Explanation states that even after the proposed treaty has been terminated, a taxpayer may bring to the competent authorities a case involving a year for which the proposed treaty was in force.

The Technical Explanation addresses cases involving the taxing jurisdictions of more than two countries. The example given is where a parent corporation resident in country A engages in transactions with its subsidiaries in countries B and C. The Technical Explanation notes that if there is a complete network of treaties among the three countries, the competent authorities of those countries should be able to agree on a three-sided solution to a problem.

A person may seek relief under the mutual agreement procedure even if the person is not generally entitled to benefits under the limitation on benefits rules of the proposed treaty.

Article 25. Exchange of Information and Administrative Assistance

The proposed treaty generally provides that the two competent authorities will exchange such information as may be relevant in carrying out the provisions of the proposed treaty or in carrying out the provisions of the domestic laws of the two treaty countries concerning all taxes of any kind imposed by a treaty country. The Technical Explanation notes that the phrase "may be relevant" incorporates the standard in Code section 7602. This standard authorizes the IRS to examine data that "may be relevant or material," meaning data of potential relevance regardless of whether it would be admissible in court. The Technical Explanation states that the "may be relevant" standard does not permit a treaty country to request information about all bank accounts maintained by its residents in the other treaty country or about all bank accounts maintained by its residents with a particular bank. The general rule providing for information exchange between the two competent authorities and the rules described below are broadly similar to the information exchange and administrative assistance rules in the U.S. Model.

Exchange of information is not restricted by paragraph 1 of Article 1 (General Scope). Accordingly, information about persons who are residents of neither Bulgaria nor the United States may be requested and provided under this article. For example, according to the Technical Explanation, if a third-country resident has a Bulgarian bank account and the U.S. Internal Revenue Service believes that funds in the account should have been, but have not been, reported to the IRS, the U.S. competent authority may request information from Bulgaria about the bank account even though the owner of the account is not the taxpayer under examination.

Exchange of information also is not restricted by Article 2 (Taxes Covered). The competent authorities may exchange information relating to, for example, U.S. estate and gift taxes, U.S. excise taxes, and Bulgarian value added taxes.

The proposed treaty provides that information exchange relating to each treaty country's domestic law is authorized to the extent that taxation under that law is not contrary to the proposed treaty. According to the Technical Explanation, the competent authority of one treaty country may request information about a transaction from the competent authority of another treaty country even if the transaction to which the information relates is a purely domestic transaction in the requested country and information exchange about the transaction would not be undertaken to carry out the proposed treaty. As an example, the Technical Explanation states (referencing the OECD Model) that if a U.S. company and a Bulgarian company transact with one another through a company resident in a third country that has no treaty with the United States or Bulgaria, the U.S. and Bulgarian competent authorities may, to enforce their internal rules, exchange information about prices their resident companies paid in their transactions with the third-country company.

The proposed treaty provides that exchange of information may include information relating to the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the proposed treaty. Consequently, the competent authorities may exchange information about collection cases, cases under civil examination or criminal investigation, and cases being prosecuted.

The proposed treaty provides that if specifically requested by the competent authority of a treaty country, the competent authority of the other treaty country must provide information under this article in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings). The Technical Explanation notes that the intent of this rule is to ensure that information may be introduced as evidence in the judicial proceedings of the treaty country making the request and that the requested state should provide the information in the form requested to the same extent that it can obtain information in that form under its own laws and administrative practices.

Any information exchanged under the proposed treaty must be treated as secret in the same manner as information obtained under the domestic laws of the treaty country receiving the information. The exchanged information may be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes to which the proposed treaty applies, or to persons or authorities engaged in the oversight of those taxes (for example, according to the Technical Explanation, the tax-writing committees of Congress and the General Accounting Office). The persons or authorities receiving information must use the information only in the performance of their official roles. Exchanged information may be disclosed in public court proceedings or in judicial decisions.

As is true under the U.S. Model and the OECD Model, under the proposed treaty a country is not required to carry out administrative measures at variance with the laws and administrative practice of either treaty country; to supply information that is not obtainable under the laws or in the normal administrative practice of either treaty country; or to supply information that would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy. The Technical Explanation notes, however, that if a treaty country is asked to provide information, it should provide the information even if its own statute of limitations period has expired for the issue to which the information relates. According to the Technical Explanation, the statute of limitations of the treaty country making the request should govern. The Technical Explanation also states that even if the limitations on information exchange mean that a treaty country is not obligated to supply information in response to a request from the other treaty country, the requested country may choose to supply the information if doing so does not violate its internal law.

If information is requested by a treaty country in accordance with this article, the proposed treaty provides that the requested treaty country must use its information gathering measures to obtain the requested information even though that requested country may not need the information for its own purposes. This obligation is subject to the limitations described previously, but in no case may those limitations be construed to permit a treaty country to decline to supply information because it has no domestic interest in the information. According to the Technical Explanation, this rule clarifies that the limitations on information exchange described previously do not prevent a treaty country from requesting information from a bank or a fiduciary that the treaty country does not need for its own tax purposes.

Neither treaty country is permitted to decline to supply information because the information is held by a bank, another financial institution, a nominee, or a person acting in an

agency or a fiduciary capacity, or because the information relates to ownership interests in a person (such as the identity of a beneficial owner of bearer shares). According to the Technical Explanation, this rule prevents a treaty country from relying on the limitations on information exchange described above to argue that its domestic bank secrecy laws (or similar rules) override its general obligation to provide information.

The Technical Explanation notes that once the proposed treaty is in force, the competent authority may seek information relating to a year before the treaty's entry into force. The competent authorities also may seek information relating to a year for which the treaty was in force after the treaty has been terminated.

Article 26. Members of Diplomatic Missions and Consular Posts

The proposed treaty contains the rule (also found in the U.S. Model treaty and other U.S. tax treaties) that its provisions do not affect the fiscal privileges of members of diplomatic missions or consular posts as are provided for under the general rules of international law or under the provisions of special agreements. Accordingly, the proposed treaty will not preempt the exemption from tax that a host country may grant to the salary of diplomatic officials of the other treaty country. The saving clause is not taken into account in the application of this article to host country residents (i.e., persons who are resident for purposes of the treaty) who are neither citizens nor lawful permanent residents (i.e., permanently resident for immigration law purposes) of the host country. Thus, for example, Bulgarian diplomats who are considered residents of the United States for purposes of the treaty (but not for purposes of U.S. immigration law) may be protected from U.S. tax.

Article 27. Entry into Force

The proposed treaty is subject to ratification in accordance with the applicable procedures of each treaty country. Each treaty country shall notify the other in writing, through diplomatic channels, when it has completed the required procedures. Generally, the proposed treaty will enter into force on the date of the later of the notifications made through diplomatic channels regarding the completion of the required ratification procedures. The Technical Explanation clarifies the rule, stating the relevant date is the date on which the notice is received by the other treaty country.

With respect to withholding taxes, the provisions of the proposed treaty will have effect for amounts paid or credited on or after the first day of January next following the date on which the proposed treaty enters into force. With respect to other taxes, the provisions of the proposed treaty will have effect for taxable periods beginning on or after the first day of January next following the date on which the proposed treaty enters into force.

Paragraph 11 of the proposed 2007 protocol and the Technical Explanation note that the powers given to the competent authority under Article 25 (Exchange of Information) apply without regard to the taxable period to which the matter relates, meaning that the exchange of information provisions of the proposed treaty may be exercised even if the proposed treaty was not in effect during the years in which the transaction at issue occurred.

Article 28. Termination

Article 28 (Termination) provides that the proposed treaty will remain in force indefinitely, but that either of the treaty countries may terminate the treaty by giving written notice of termination to the other treaty country not later than June 30 of any calendar year. In the event of termination, the treaty will cease to have effect with respect to withholding taxes for amounts paid or credited on or after the first day of January in the calendar year following the year in which notice of termination was given. With respect to other taxes, the treaty will cease to have effect for any taxable period that begins on or after the first day of January in the calendar year following the year in which the notice of termination was given. Thus, if a termination notice is given on May 1, 2015, then the treaty will terminate with respect to withholding taxes on January 1, 2016. For a calendar year company, the treaty will terminate on January 1, 2016, with respect to taxes chargeable to the taxable period beginning January 1, 2016. For a company with a November 30 fiscal year end, the treaty will terminate December 1, 2016, with respect to taxes chargeable to the taxable period beginning December 1, 2016.

VI. ISSUES

A. Students, Trainees, Teachers and Researchers

Treatment under proposed treaty

Under the proposed treaty (Article 19), teachers and researchers who are residents of one treaty country and who visit the other treaty country (host country) are entitled to an exemption from host country taxation on designated classes of income for a period not exceeding two years from the date of arrival. The purpose of the visit must be teaching or carrying on research at a college, university, or other recognized educational institution.

The proposed treaty's treatment of students and business trainees (Article 19) corresponds to the U.S. Model treaty. Under the proposed treaty, students and business trainees are exempt from host country income tax on payments arising from outside the host country received for maintenance, education, or training if the purpose of the visit is to engage in full-time training or full-time education at a college, university, or other recognized educational institution of a similar nature. Business trainees are individuals who are temporarily in the host country to secure training to practice a profession or professional specialty or individuals who are employed by a resident of the other country and whose purpose is to acquire technical, professional, or business experience from someone other than their employer or someone related to their employer. While the payments received by students are exempt so long as the purpose of their visit is to engage in full-time education, the exemption for business trainees is limited to a period not exceeding two years from the date of arrival in the host country for the purpose of training.

Under the proposed treaty, students and business trainees may also exempt an aggregate amount of \$9,000 U.S. dollars or its Bulgarian currency equivalent annually of income from personal services performed in the host country. The exemption for the personal services income of business trainees is limited to a period of two years from the date of arrival in the host country.

Issues

Teachers and researchers

Unlike the U.S. Model treaty, the proposed treaty provides an exemption from host country income tax for income an individual receives from teaching or research in the host country. Under section 911, a U.S. citizen or resident may elect to exclude \$87,600 (for 2008) of non-U.S. source earned income attributable to personal services performed by the citizen or resident.⁵² Additionally, such an individual may exclude or deduct from gross income certain foreign housing costs paid or incurred by or on behalf of the individual. Section 911 in conjunction with the proposed treaty provision allows a teacher or researcher to receive

⁵² The amount is indexed for inflation; the 2008 amount is \$87,600. Code sec. 911(b)(2)(D); Rev. Proc. 2007-66, 2007-45 I.R.B. 970 (November 5, 2007).

remuneration of up to \$87,600 plus certain housing costs tax free. Likewise, under the proposed treaty, a Bulgarian teacher or researcher is exempt for a period of two years or less from U.S. income tax on income earned while visiting the United States for the purpose of engaging in teaching or research.

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

On the other hand, complete exemption from income tax in both the United States and Bulgaria may be seen as unfair when compared to other persons who must temporarily relocate abroad for their occupation or employment. The income of a U.S. citizen or permanent resident who is not a teacher or researcher and who temporarily takes up residence and employment in Bulgaria is subject to Bulgarian income tax; the income may also be subject to U.S. income tax to the extent it is in excess of the section 911 limitation. Likewise, the income of a Bulgarian resident who is not a teacher or researcher and who temporarily takes up residence and employment in the United States is subject to U.S. income tax. Thus, the proposed treaty could be viewed as violating the principle of horizontal equity by treating otherwise similarly economically situated taxpayers differently.

The U.S. Model treaty includes no exemption for the remuneration of visiting teachers or researchers. An exception for visiting teachers and professors has been included in many bilateral tax treaties. The Committee may wish to satisfy itself that the inclusion of an exemption for a limited class of individuals is appropriate.

Full-time students and trainees

The proposed treaty generally has the effect of exempting from the income tax of both treaty countries certain payments. The exempt payments are those arising outside the host country that are received for the maintenance, education, and training of full-time students and full-time trainees as visitors from one treaty country to the other. This exemption conforms to the U.S. Model treaty and the OECD Model treaty provisions. Under the proposed treaty, full-time students and trainees may also earn up to \$9,000 U.S. dollars or its Bulgarian currency equivalent annually in tax-free personal services income. This personal service income exemption is similar to a provision in the U.S. Model treaty but departs from the OECD Model treaty. This provision generally would have the effect of reducing the cost of education and training received by visitors, which may encourage individuals to consider study abroad in the other treaty country. Such cross-border visits by students and trainees may foster the advancement of knowledge and redound to the benefit of residents of both countries.

In the case of business trainees, the proposed treaty limits the exemption for such payments to a period of two years or less. By potentially subjecting such payments to host country income tax,

the cost for cross-border visitors of engaging in such longer duration training programs would be increased. This increased cost may discourage visitors to such programs in either country. It could be argued that the training of a business trainee relates primarily to specific job skills of value to the individual or the individual's employer rather than enhancing general knowledge and cross-border understanding, as may be the case in the education of a full-time student. This could provide a rationale for providing more open-ended treaty benefits in the case of students as opposed to business trainees. However, this rationale raises a question as to why training requiring two years or less is preferred to training that requires a longer visit to the host country. As such, the proposed treaty would favor certain types of training arrangements over others. The OECD Model treaty does not limit the duration of exemption for payments for maintenance, education, and training for business trainees; the U.S. Model treaty limits the exemption to a period not exceeding one year.

B. Permanent Establishment by Virtue of Services

In general

The proposed treaty provides a special rule for services in paragraph 8 of Article 5 (Permanent Establishment), under which services performed by an enterprise of a treaty country in the other treaty country (the “services country”) may give rise to a permanent establishment there, even in the absence of a permanent establishment under another paragraph of Article 5. If paragraph 8 applies, the services are taxed on a net basis under Article 7 (Business Profits) of the proposed treaty, and, therefore, such taxation is limited to the profits attributable to the activities carried on in performing those services. The effect of this provision is that the services country is more likely to be able to impose its tax on profits of business enterprises that are resident in the other treaty country, even though this tax is limited to profits from the permanent establishment.

The United States has negotiated several tax treaties that contain a similar rule providing that cross-border services may give rise to a permanent establishment under certain circumstances. The circumstances that may give rise to a permanent establishment under those treaties, as well as the relevant time periods that will trigger the provision, generally vary by treaty. These treaties include the U.S.-India treaty (1989), the U.S.-Philippines treaty (1976), the U.S.-Slovak Republic treaty (1993), the U.S.-Venezuela tax treaty (1999), and the U.S.-Thailand treaty (1996). All of these treaties are with developing countries.⁵³ The proposed protocol to the U.S.-Canada treaty also contains a provision very similar to the provision in the proposed treaty.

Administrative and compliance issues

The rules of paragraph 8 may give rise to administrative and compliance issues, including the potential for excess withholding or estimated tax payments with respect to employee wages that may result from the application of paragraph 8 and its interaction with Article 14 (Income from Employment). It is not clear that, or how, these potential issues will be resolved. In any event, taxpayers will be required to establish systems and processes to address these matters, some of which affect the enterprise and some of which affect its employees.

Enterprise issues

Some of the issues that may arise under paragraph 8 result from the fact that an enterprise with a deemed permanent establishment in another country that is not an actual fixed base is unlikely to have the requisite infrastructure in that other country to comply with the rules of paragraph 8. For example, such an enterprise is unlikely to keep in the services country a full set of enterprise financial records or records tracking its employees’ activities there. Such records will likely have to be established and maintained in the enterprise’s home country. In addition, there will probably be no permanent employees in the services country to implement the enterprise’s tax compliance efforts, including the payment or deposit of any required estimated

⁵³ The United Nations Model Taxation Convention between Developed and Developing Countries (January 11, 2001) also contains such a provision.

taxes, and the filing of tax returns with the various levels of government. It may be necessary for the enterprise to anticipate that it might later be deemed to have a permanent establishment under this provision. Depending on the situation, that may be difficult or impossible to foresee (for example, if planned project deadlines are not met due to unanticipated circumstances, or if services are unexpectedly required to be performed for more than 183 days in order to finish the work).

Employee-employer issues

The potential triggering of a permanent establishment raises several issues for the employees involved as well as for the enterprise in its capacity as employer.

Under Article 14 of the proposed treaty, remuneration of an employee who is a resident of a treaty country is generally taxable only in that treaty country unless the employment is exercised in the other treaty country (i.e., the services country). In the case of such cross-border employment, the proposed treaty provides that the remuneration derived by the employee from the exercise of employment in the other treaty country may be taxed by the services country if the recipient is present in the services country for a period or periods equal to or exceeding in the aggregate 183 days in any 12-month period commencing or ending in the taxable year concerned, the remuneration is paid by (or on behalf of) a person who is a resident of the services country, or the remuneration is borne by a permanent establishment in the services country.⁵⁴

Thus, an employee performing services through a permanent establishment arising under new paragraph 8 of Article 5 of the proposed treaty would be subject, under Article 14 of the proposed treaty, to income taxation by the services country on the remuneration from such exercise of employment. This may give rise to several tax-related obligations on the part of the employee and the employer, including the registration and the obtaining of tax identification numbers, withholding and deposit of income taxes and other taxes with respect to both the employer and the employee (covering the period beginning on the first day such services were performed by such employee during the year), and in the case of an enterprise that is a partnership, the filing of income tax returns on behalf of the partners.

The Committee may wish to inquire whether and how the administrative and compliance issues described above have been (or will be) addressed by the treaty partners.

The draft OECD Model treaty commentary

On April 21, 2008, the OECD issued a draft update to its Model treaty.⁵⁵ The OECD update includes amendments to the commentary that generally address the tax treaty treatment of

⁵⁴ For this purpose, a permanent establishment bears the remuneration if the remuneration is economically incurred by the permanent establishment. This will generally be the case because such remuneration is incurred for the purposes of the permanent establishment.

⁵⁵ *Draft Contents of the 2008 Update to the Model Tax Convention*, OECD Centre for Tax Policy and Administration (April 21, 2008). The OECD reportedly announced it will soon release the final

services. The draft commentary also includes an example of an alternative services permanent establishment provision that, according to the commentary, treaty countries “are free to agree bilaterally to include.....in their tax treaties.”⁵⁶

Although the alternative OECD language is generally similar to that of the proposed treaty, there are some notable differences. Most significantly, the alternative OECD language clarifies when services performed by an individual on behalf of one enterprise may be considered as performed by another enterprise through that individual. Under the alternative OECD provision, such attribution may occur only if the other enterprise supervises, directs, or controls the manner in which the services are performed by the individual. The proposed treaty and the Technical Explanation are silent on this point, leaving open the question whether, and if so, under what circumstances, the use of a subcontractor might give rise to a permanent establishment of a general contractor under paragraph 8.

There are two other significant differences between paragraph 8 and the alternative OECD provision. First, unlike new paragraph 8(b) of Article 5 of the proposed treaty, corresponding subparagraph (b) of the alternative OECD provision is clear on its face that the individuals must be physically present in the services country. In this regard, however, the Technical Explanation clarifies that physical presence is required under the proposed treaty.⁵⁷ Second, under the proposed treaty, in order for projects to be considered to be connected, they must constitute a coherent whole, both commercially and geographically. Geographic coherence is not required under the alternative OECD provision.

The Committee may wish to inquire regarding the circumstances, if any, which might give rise to a permanent establishment for a general contractor that hires a local or other subcontractor but does not send any of its own employees to perform services in the services country.

version of the update, which the OECD is expected to formally approve on July 17, 2008. Thus, it is possible that the final version differs from the publicly-released draft update described herein. See *OECD Updates Model Tax Convention*, 2008 Worldwide Tax Daily 127-1 (July 1, 2008).

⁵⁶ *Annex I to the Draft Contents of the 2008 Update to the Model Tax Convention*, par. 42.23, OECD Centre for Tax Policy and Administration (April 21, 2008).

⁵⁷ Although the Technical Explanation does indicate the Department of the Treasury’s interpretation of the treaty, that interpretation is not legally binding on Bulgaria.