

[JOINT COMMITTEE PRINT]

**EXPLANATION OF PROPOSED
INCOME TAX TREATY AND
PROPOSED PROTOCOL BETWEEN
THE UNITED STATES AND
THE REPUBLIC OF TURKEY**

SCHEDULED FOR A HEARING

BEFORE THE

**COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE**

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PREPARED BY THE STAFF

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INTRODUCTION

This pamphlet,¹ prepared by the staff of the Joint Committee on Taxation, describes the proposed income tax treaty, as supplemented by the proposed protocol, between the United States of America and the Republic of Turkey ("Turkey"). The proposed treaty and protocol were both signed on March 28, 1996.² The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed treaty and protocol on October 7, 1997.

Part I of the pamphlet provides a summary with respect to the proposed treaty and protocol. 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 an article-by-Article explanation of the proposed treaty and protocol. Part IV contains a discussion of issues with respect to the proposed treaty and protocol.

¹This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty and Proposed Protocol Between the United States and the Republic of Turkey* (JCS-13-97), October 6, 1997.

²For a copy of the proposed treaty and protocol, see Senate Treaty Doc. 104-30, September 4, 1996.

I. SUMMARY

The principal purposes of the proposed income tax treaty between the United States and Turkey are to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country and to prevent avoidance or evasion of the taxes of the two countries. The proposed treaty 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 or fixed base (Articles 7 and 14). Similarly, the proposed treaty contains "commercial visitor" exemptions under which residents of one country performing personal services in the other country will not be required to pay tax in the other country unless their contact with the other country exceeds specified minimums (Articles 14, 15, and 17). The proposed treaty provides that dividends, interest, royalties, and certain capital gains derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles 10, 11, 12, and 13); however, the rate of tax that the source country may impose on a resident of the other country on dividends, interest, and royalties generally will be limited by the proposed treaty (Articles 10, 11, and 12).

In situations where the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the proposed treaty generally provides for relief from the potential double taxation through the allowance by the country of residence of a tax credit for certain foreign taxes paid to the other country (Article 23).

The proposed treaty contains the standard provision (the "saving clause") included in U.S. tax treaties pursuant to which each country retains the right to tax its residents (and citizens in the case of the United States) 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 to under the domestic law of a country or under any other agreement between the two countries (Article 1).

No income tax treaty between the United States and Turkey is in force at present. The proposed treaty (as supplemented by the proposed protocol) is similar to other recent U.S. income tax treaties, the 1996 U.S. model income tax treaty ("U.S. model"),³ and the 1992 model income tax treaty of the Organization for Economic Cooperation and Development ("OECD model"). However, the proposed treaty contains certain substantive deviations from those treaties and models.

³The Treasury Department released the U.S. model on September 20, 1996. A 1981 U.S. model treaty was withdrawn by the Treasury Department on July 17, 1992.

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 1 or 4 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, a special limitation applies to the credit for foreign taxes imposed on foreign oil and gas extraction 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 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 from 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 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 that 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. EXPLANATION OF PROPOSED TREATY

A detailed, article-by-article explanation of the proposed income tax treaty between the United States and Turkey is set forth below. The provisions of the proposed protocol are covered together with the relevant articles of the proposed treaty.

Article 1. Personal Scope

Overview

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

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

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

to claim the loss of the unprofitable business that does not constitute a permanent establishment to offset the taxable income of the permanent establishment.⁴

Saving clause

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

The proposed treaty contains a provision under which the saving clause (and therefore the U.S. jurisdiction to tax) applies to a former U.S. citizen whose loss of citizenship had as one of its principal purposes the avoidance of tax; such application is limited to the ten-year period following the loss of citizenship. Prior to the enactment of the Health Insurance Portability and Accountability Act of 1996, section 877 of the Code provided special rules for the imposition of U.S. income tax on former U.S. citizens for a period of ten years following the loss of citizenship; these special tax rules applied to a former citizen only if his or her loss of U.S. citizenship had as one of its principal purposes the avoidance of U.S. income, estate or gift taxes. The Health Insurance Portability and Accountability Act of 1996 expanded section 877 in several respects. Under these amendments, the special income tax rules of section 877 were extended to apply also to certain former long-term residents of the United States. For purposes of applying the special tax rules to former citizens and long-term residents, individuals who meet a specified income tax liability threshold or a specified net worth threshold generally are considered to have lost citizenship or resident status for a principal purpose of U.S. tax avoidance. In addition, an expanded foreign tax credit is provided with respect to the U.S. tax imposed under these rules. The amendments to section 877 generally are applicable to individuals whose loss of U.S. citizenship or U.S. resident status occurred on or after February 6, 1995. The proposed treaty provision reflects the reach of the U.S. tax jurisdiction pursuant to section 877 prior to its expansion by the Health Insurance Portability and Accountability Act of 1996. Accordingly, the saving clause in the proposed treaty does not permit the United States to impose tax on former U.S. long-term residents who otherwise would be subject to the special income tax rules contained in the Code.

Exceptions to the saving clause are provided for the following benefits conferred by a treaty country: the allowance of correlative adjustments when the profits of an associated enterprise are adjusted by the other country (Article 9, paragraph 2); the exemption from residence country tax for social security benefits (Article 18,

⁴See Rev. Rul. 84-17, 1984-1 C.B. 308.

paragraph 2); relief from double taxation through the provision of a foreign tax credit (Article 23); protection from discriminatory tax treatment with respect to transactions with residents of the other country (Article 24); and benefits under the mutual agreement procedures (Article 25). These exceptions to the saving clause permit residents of the United States or Turkey and citizens of the United States to obtain such benefits of the proposed treaty with respect to their country of residence (or citizenship).

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

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

Article 2. Taxes Covered

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

In the case of the United States, the proposed treaty applies to the Federal income taxes imposed by the Code, but excludes the accumulated earnings tax, the personal holding company tax, and social security taxes. The proposed treaty also applies to the excise taxes imposed with respect to private foundations.

In the case of Turkey, the proposed treaty applies to the income tax (Gelir Vergisi), the corporation tax (Kurumlar Vergisi), and the levy imposed on the income and corporation taxes.

The proposed treaty also contains a rule generally found in U.S. income tax treaties which provides that the proposed treaty applies to any identical or substantially similar taxes that may be imposed

subsequently in addition to or in place of the taxes covered. The proposed treaty obligates the competent authority of each country to notify the competent authority of the other country of any significant changes in its internal tax laws. The Technical Explanation states that this requirement relates to changes that are significant to the operation of the proposed treaty.

Article 3. General Definitions

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

The term "Turkey" means the territory of the Republic of Turkey, as well as the continental shelf over which Turkey has, in accordance with international law, sovereign rights to explore and exploit its natural resources.

The term "United States" means the United States of America, but does not include Puerto Rico, the Virgin Islands, Guam, or any other U.S. possession or territory. When used in the geographic sense, the term "United States" means the States, the District of Columbia, and the internal waters and territorial sea established in accordance with international law; it also includes the seas, seabed and subsoil adjacent to the territorial sea over which the United States has sovereign rights in accordance with international law. The Technical Explanation states that the continental shelves of Turkey and the United States are included only to the extent that the application of the proposed treaty to the continental shelf is consistent with international law and is connected with the exploration or exploitation of the natural resources of the shelf.

The term "person" includes an individual, a company, and any other body of persons. According to the Technical Explanation, the term is understood to include a partnership, estate, or trust.

A "company" under the proposed treaty is any body corporate or any entity which is treated as a body corporate for tax purposes. The Technical Explanation states that, for U.S. tax purposes, the principles of Treas. Reg. section 301.7701-2 generally are applicable in determining whether an entity is taxed as a body corporate.

A company is considered to have its "place of incorporation" in the United States if it is organized, created, or incorporated under the laws of the United States or a political subdivision thereof. A company is considered to have its "place of incorporation" in Turkey if its legal head office is registered in Turkey under the Turkish Code of Commerce.

A person is a "national" of Turkey if the person is an individual possessing Turkish nationality under the Turkish Nationality Code or is a legal person, partnership, or association deriving its status as such from Turkish law. A person is a "national" of the United States if the person is an individual who is a U.S. citizen or is a company, association, or other entity deriving its status as such from the laws of the United States or a political subdivision.

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 Contracting State and an enterprise carried on by a resident of the other Contracting State. The proposed

treaty does not define the term "enterprise." The terms "a Contracting State" and "the other Contracting State" mean the United States or Turkey, according to the context in which such terms are used.

The U.S. "competent authority" is the Secretary of the Treasury or his delegate. The U.S. competent authority function has been delegated to the Commissioner of Internal Revenue, who has re-delegated the authority to the Assistant Commissioner (International). On interpretative issues, the latter acts with the concurrence of the Associate Chief Counsel (International) of the IRS. The Turkish "competent authority" is the Minister of Finance or his authorized representatives.

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

The proposed treaty also contains the standard provision that, unless the context otherwise requires or the competent authorities agree to a common meaning, all terms not defined in the treaty have the meaning that they have under the tax laws of the country that is applying the treaty. The Technical Explanation states that where a term is defined both under a country's tax law and under a non-tax law, the definition in the tax law is to be used in applying the proposed treaty.

Article 4. Resident

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

Internal taxation rules

United States

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

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

Turkey

Under Turkish law, resident individuals are subject to tax on their worldwide income, while nonresident individuals are subject to tax only on certain income derived in Turkey. A foreign individual generally is considered a resident if the individual is present in Turkey for an uninterrupted period of more than six months during a calendar year (other than because of imprisonment, illness, or assignment for specific, temporary projects).

Under Turkish law, a corporation generally is subject to tax on its worldwide income if the corporation's legal head office or actual business center is located in Turkey. A corporation that is established in Turkey under the Turkish Commercial Code is subject to tax on its worldwide income. Corporations that are taxable on their worldwide income are "unlimited" taxpayers; other corporations, that are taxable only on certain income derived in Turkey, are "limited" taxpayers.

Proposed treaty rules

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

The proposed treaty generally defines "resident of a Contracting State" to mean any person who, under the laws of that country, is liable to tax in that country by reason of the person's domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature. The term "resident of a Contracting State" does not include any person that is liable to tax in that country only on income from sources in that country. According to the Technical Explanation, the reference in the proposed treaty to persons "liable to tax" in a country is interpreted as referring to those persons subject to the taxation laws of such country; the reference therefore includes tax-exempt organizations that are subject to the tax laws of a country (even though such organizations are exempt from tax). Although citizenship is not specifically listed as one of the bases for taxing jurisdiction that establishes residence, the Technical Explanation states that citizenship is understood to be a "criterion of a similar nature" within the meaning of the proposed treaty definition. The proposed protocol provides, however, that a citizen or national of a treaty country may be considered to be a resident of a third country for purposes of the proposed treaty. The determination of whether a citizen or national is considered a resident of the United States or Turkey or a resident of a third country is made based on the principles of the treaty tie-breaker rules described below.

The proposed treaty provides that a partnership or similar pass-through entity, estate, or trust is considered to be a resident of one of the treaty countries only to the extent that the income it derives is subject to tax in that country as the income of a resident, either in its hands or in the hands of its partners, beneficiaries, members, or grantors. The Technical Explanation states that the phrase "similar pass-through entity" includes a U.S. limited liability company that is classified as a partnership for U.S. tax purposes. Under this provision, for example, if the U.S. partners' share of the

income of a U.S. partnership is only one-half, the proposed treaty's limitations on withholding tax rates would apply to only one-half of the Turkish source income paid to the partnership.

The Technical Explanation states that it is understood that the treaty countries themselves, and political subdivisions thereof, are to be treated as residents of such countries for purposes of the proposed treaty.

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

A company that would be a resident of both countries under the basic definition in the proposed treaty is deemed to be a resident of the country in which it has its place of incorporation (as defined in Article 3 (General Definitions)). In the case of any other person that would be a resident of both countries under the basic definition in the proposed treaty, the proposed treaty requires the competent authorities to settle the issue of residence by mutual agreement and to determine the mode of application of the proposed treaty to such person.

Article 5. Permanent Establishment

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

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

In general, under the proposed treaty, a permanent establishment is a fixed place of business through 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 any other

place of extraction of natural resources. It also includes a building site or a construction, assembly, or installation project, if the site, project, or activities continue 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 U.S. and OECD models contain similar rules, but the threshold period is twelve months rather than six months.

The proposed protocol provides that the mere presence of an installation or drilling rig or ship used for the exploration or exploitation of natural resources will never constitute a permanent establishment. If, however, a resident of one country carries on drilling activities in the other country for periods exceeding 183 days in any continuous twelve-month period or performs such activities through a permanent establishment other than the installation, rig or ship, that presence or performance is treated as analogous to a permanent establishment. The six-month period for establishing a permanent establishment in connection with a site, project, rig, or ship is significantly shorter than the twelve-month period provided in the corresponding rule of the U.S. model, but is similar to the periods contained in U.S. treaties with some developing countries.

Under the proposed treaty, the following activities are deemed not to constitute a permanent establishment: the use of facilities solely for storing, displaying, or delivering goods or merchandise belonging to the enterprise; the maintenance of a stock of goods or merchandise belonging to the enterprise solely for storage, display, or delivery or solely for processing by another enterprise; the maintenance of a fixed place of business solely for the purchase of goods or merchandise or for the collection of information for the enterprise; and 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. The Technical Explanation gives advertising (other than by an advertising company), supplying information, and conducting scientific activities as examples of such preparatory and auxiliary activities.

Under the U.S. model, the maintenance of a fixed place of business solely for any combination of the above-listed activities does not constitute a permanent establishment. Under the proposed treaty (as under the OECD Model), a fixed place of business used solely for any combination of these activities does not constitute a permanent establishment, provided that the overall activity of the fixed place of business is of a preparatory or auxiliary character. In this regard, the Technical Explanation states that it is assumed that a combination of preparatory or auxiliary activities generally will also be of a character that is preparatory or auxiliary.

Under the proposed treaty, if a person, other than an independent agent, is acting in a treaty country on behalf of an enterprise of the other country and has, and habitually exercises, the authority to conclude contracts on behalf of such enterprise, the enterprise is deemed to have a permanent establishment in the first

country in respect of any activities undertaken for that enterprise. This rule does not apply where the contracting authority is limited to the activities listed above, such as storage, display, or delivery of merchandise, which are excluded from the definition of a permanent establishment.

The proposed treaty contains an additional rule that deems an enterprise to have a permanent establishment in country if the agent has no authority to conclude contracts on behalf of the enterprise, but the agent habitually maintains in the country a stock of goods or merchandise from which the agent regularly delivers goods or merchandise on behalf of the enterprise. This rule applies only if the agent undertakes virtually all the activities connected with the sale of such goods (except the conclusion of the contract) and it is proven that this structure is established in order to avoid tax in such country.

Under the proposed treaty, no permanent establishment is deemed to arise if the agent is a broker, general commission agent, or any other agent of independent status, provided that the agent is acting in the ordinary course of its business. The Technical Explanation states that whether an enterprise and an agent are independent is a factual determination; relevant factors include the extent to which the agent operates based on instructions from the enterprise and which party bears the risk associated with the agent's activities on behalf of the enterprise.

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 engages in business in the other country does not of itself cause either company to be a permanent establishment of the other. Thus, such relationships would not be relevant to the determination of whether a company is a permanent establishment.

Article 6. Income from Immovable Property (Real Property)

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

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

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

The proposed treaty specifies that the country in which the property is situated also may tax income derived from the direct use,

letting, or use in any other form of immovable property. The proposed treaty further provides that the rules of this article permitting source country taxation apply to the income from immovable property of an enterprise and to income from immovable property used for the performance of independent personal services.

Article 7. Business Profits

Internal taxation rules

United States

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

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

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

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

erty occurring within ten years after the cessation of business is effectively connected with the conduct of a trade or business within the United States is made as if the sale or exchange occurred immediately before the cessation of business (Code sec. 864(c)(7)).

Turkey

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

Proposed treaty limitations on internal law

Business profits subject to host country tax

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

Under the proposed protocol, business profits of an enterprise of one country may be taxable in the other country even though the permanent establishment was not involved in the generation of such profits if two conditions are met. First, the profits must be derived either from the sale of goods of the same or similar kind as those sold through the permanent establishment or from other business activities of the same or similar kind as those effected through the permanent establishment. Second, it must be proved that the sale or activities were structured in a manner intended to avoid taxation in the country in which the permanent establishment is located. Taxation by the source country of this category of profits represents a limited force of attraction rule that is similar to, but narrower than, the rule in some other U.S. treaties. The intent of the provision is to permit the source country to tax the income derived from sales or other business activities within its borders by the home office of the enterprise if such sales or activities are the same as or similar to sales or activities conducted there by the permanent establishment. Such profits may not be taxed by the source country, however, unless it is established that the transactions were structured to avoid such tax.

The taxation of business profits under the proposed treaty differs from U.S. internal law rules for taxing business profits primarily by requiring more than merely being engaged in a trade or business before a country can tax business profits and by substituting an "attributable to" standard for the Code's "effectively connected" standard. Under the proposed treaty, some level of fixed place of business would have to be present and the business profits generally would have to be attributable to that fixed place of business (or subject to the limited force of attraction rule described above).

The proposed protocol provides that, for purposes of the taxation of business profits, income may be attributable to a permanent es-

establishment (and therefore may be taxable in the country where the permanent establishment was situated) even if the payment of such income is deferred until after the permanent establishment has ceased to exist. This rule incorporates into the proposed treaty the rule of Code section 864(c)(6) described above.

The proposed treaty provides that there will be attributed to a permanent establishment the business profits which it might be expected to make if it were a distinct and independent entity engaged in the same or similar activities under the same or similar conditions. The Technical Explanation states that amounts may be attributed to the permanent establishment whether or not they are from sources within the country in which the permanent establishment is located. The Technical Explanation further states that the permanent establishment is to be treated as if it were an enterprise that deals independently with all related companies.

As noted above in connection with Article 5 (Permanent Establishment), the proposed protocol provides a special rule with respect to the treatment of income from offshore exploration. Income from an installation or drilling rig or ship used for the exploration or exploitation of natural resources is considered to be business profits (or independent personal services income). Such income derived by an enterprise of one country from activities performed in the other country may be taxed by the other country if the enterprise has a permanent establishment other than the installation or drilling rig or ship itself in the other country through which the activities are performed or if the periods during which the activities are performed exceed 183 days in any continuous twelve-month period.

Treatment of expenses

In computing taxable business profits, the proposed treaty provides that deductions are allowed for expenses, wherever incurred, which are incurred for the purposes of the permanent establishment. These deductions include executive and general administrative expenses incurred for purposes of the permanent establishment.

Unlike many U.S. treaties, the proposed treaty does not specifically provide that deductions will be allowed for a reasonable allocation of expenses. However, the Technical Explanation states that certain expenses (e.g., interest) may be allocated.

The proposed protocol clarifies that deductions will not be allowed for interest, royalties, commissions, and other similar payments by the permanent establishment to the head office or to other permanent establishments unless such payments are reimbursements of actual expenses incurred for purposes of the permanent establishment. According to the Technical Explanation, this rule reflects the premise that because the permanent establishment and the head office are parts of a single entity, there should be no profit element in such intracompany transactions.

Other rules

Business profits are not attributed to a permanent establishment merely by reason of the purchase of goods or merchandise by the permanent establishment for the enterprise. Thus, where a perma-

ment establishment purchases goods for its head office, the business profits attributed to the permanent establishment with respect to its other activities are not increased by a profit element in its purchasing activities.

The proposed treaty contains the language of the U.S. model and many existing treaties under which the business profits to be attributed to the permanent establishment include only the profits derived from the assets or activities of the permanent establishment. The Technical Explanation states that the limited force of attraction rule contained in the proposed protocol (described above) takes precedence over this rule.

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

Article 8. Shipping and Air Transport

Article 8 of the proposed treaty covers income from the operation or rental of ships, aircraft, and containers in international traffic. The rules governing income from the disposition of ships, aircraft, and containers are in 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 that is organized in, or an alien individual who is resident in, a foreign country that grants an equivalent exemption to U.S. corporations and residents. The United States has entered into agreements with a number of countries providing such reciprocal exemptions.

Under the proposed treaty, profits which are derived by an enterprise of one country from the operation in international traffic of ships or aircraft ("shipping profits") are taxable only in that country, regardless of the existence of a permanent establishment in the other country. "International traffic" means any transport by a ship or aircraft operated by an enterprise of a country, except where the transport is solely between places in the other country (Article 3(1)(I) (General Definitions)).

For purposes of the proposed treaty, shipping profits subject to the rule described in the foregoing paragraph include profits derived from the rental of ships or aircraft if such rental profits are incidental to other profits from the operation of ships or aircrafts in international traffic. The Technical Explanation states that this rule applies to income from bareboat leasing of ships and aircraft and that income from leasing ships and aircraft on a full basis is considered to be income from the operation of ships and aircraft (and thus is covered under the general rule).

Like the U.S. model, the proposed treaty provides that profits of an enterprise of a country from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) used in international traffic is exempt from tax in the other country. The Technical Explanation states

that charges from the delayed return of containers and related equipment are treated as profits from the use of such containers and related equipment.

The shipping and air transport provisions of the proposed treaty apply to profits from participation in a pool, joint business, or international operating agency. This refers to various arrangements for international cooperation by carriers in shipping and air transport.

Article 9. Associated Enterprises

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

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

Under the proposed treaty, when a redetermination of tax liability has been made by one country under the provisions of this article, the other country will make an appropriate adjustment to the amount of tax paid in that country on the redetermined income if it considers an adjustment justified. In making such adjustment, due regard is to be given to other provisions of the proposed treaty, and the competent authorities of the two countries are to consult with each other if necessary. The proposed treaty's saving clause retaining full taxing jurisdiction in the country of residence or citizenship does not apply in the case of such adjustments. Accordingly, internal statute of limitations provisions do not prevent the allowance of appropriate correlative adjustments.

According to the Technical Explanation, it is understood that this article does not replace the internal law provisions that permit this type of adjustment. Adjustments are permitted under internal law provisions even if such adjustments are different from, or go beyond, the adjustments authorized by this article, provided that such adjustments are consistent with the general principles of this article permitting adjustments to reflect arm's-length terms. The Technical Explanation states that this article also permits the tax authorities of the countries to address thin capitalization issues.

Article 10. Dividends

Internal taxation rules

United States

The United States generally imposes a 30-percent tax on the gross amount of U.S.-source dividends paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not

apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In such a case, the foreign recipient is subject to U.S. tax on such dividends on a net basis at graduated rates in the same manner that a U.S. person would be taxed.

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

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

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

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

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

U.S. internal law also generally treats a regulated investment company ("RIC") as both a corporation and a conduit for income tax

purposes. The purpose of a RIC is to allow investors to hold a diversified portfolio of securities. Thus, the holder of stock in a RIC may be characterized as a portfolio investor in the stock held by the RIC, regardless of the proportion of the RIC's stock owned by the dividend recipient.

A foreign corporation engaged in the conduct of a trade or business in the United States is subject to a flat 30-percent branch profits tax on its "dividend equivalent amount." The dividend equivalent amount is the corporation's earnings and profits which are attributable to its income that is effectively connected with its U.S. trade or business, decreased by the amount of such earnings that are reinvested in business assets located in the United States (or used to reduce liabilities of the U.S. business), and increased by any such previously reinvested earnings that are withdrawn from investment in the U.S. business. The dividend equivalent amount is limited by (among other things) aggregate earnings and profits accumulated in taxable years beginning after December 31, 1986.

Turkey

Turkey generally imposes a withholding tax on all after-tax corporate profits, whether or not the profits are distributed. This withholding tax is imposed on the company at a rate of 10 percent with respect to public companies and at a rate of 20 percent with respect to all other companies. In addition, Turkey levies a 10-percent surtax on such withholding tax.

An entity that operates through a branch office in Turkey is subject to Turkish tax with respect to the income derived in Turkey. Such income is subject to corporation tax in the same manner and at the same rate as the income of a Turkish corporation. The after-tax profits of a branch also are subject to the withholding tax and the surtax described above.

Proposed treaty limitations on internal law

Under the proposed treaty, dividends paid by a resident of a treaty country to a resident of the other country may be taxed in such other country. Dividends paid by a resident of a treaty country to a resident of the other country may also be taxed by the country in which the payor is resident, but the rate of such tax is limited. Under the proposed treaty, source country taxation (i.e., taxation by the country in which the payor is resident) generally is limited to 15 percent of the gross amount of the dividend if the beneficial owner of the dividend is a company which owns at least 10 percent of the voting shares of the payor company. The source country dividend withholding tax generally is limited to 20 percent of the gross amount of the dividends paid to residents of the other country in all other cases. The rates of source country dividend withholding tax permitted under the proposed treaty are higher than those provided for in the U.S. model, the OECD model and most other U.S. income tax treaties.

As noted above, Turkey does not presently impose a traditional shareholder-level withholding tax on dividends paid to nonresident individuals and foreign corporations. However, Turkey imposes a withholding tax, together with a surtax, on all after-tax profits of a corporation, whether or not those profits are distributed as a divi-

dend. The Technical Explanation states that such withholding tax will be subject to the rules limiting the rate of tax on dividends provided for in the proposed treaty.

Under the proposed treaty, dividends paid by a U.S. RIC or by a Turkish Securities Investment Corporation or Securities Investment Fund are eligible only for the limitation that applies the 20-percent rate, regardless of the dividend recipient's percentage ownership in such entity. Dividends paid by a U.S. REIT or by a Turkish Real Estate Investment Corporation or Real Estate Investment Fund also are not eligible for the limitation that applies the 15-percent rate. Moreover, such dividends are eligible for the limitation that applies the 20-percent rate only if the dividend is beneficially owned by an individual who holds less than a 10-percent interest in the payor entity. Otherwise, dividends paid by a U.S. REIT or by a Turkish Real Estate Investment Corporation or Real Estate Investment Fund are subject to source country taxation at the full statutory rate.

The proposed treaty provides a definition of "dividends" that is broader than the definition in the U.S. model, the OECD model and some other recent U.S. treaties. The proposed treaty generally defines "dividends" as income from shares, "jouissance" shares or "jouissance" rights, founders' shares, or other rights which participate in profits and which are not debt claims. The term also includes income from other corporate rights if such income is subjected to the same tax treatment by the country in which the distributing corporation is resident as income from shares. The proposed treaty also provides that the term "dividends" includes income from arrangements, including debt obligations, that carry the right to participate in (or are determined by reference to) profits, to the extent such income is so characterized under the laws of the country in which the income arises. The proposed protocol further provides that it is understood that the term "dividends" includes distributions from Turkish Securities Investment Funds and Real Estate Investment Funds.

The proposed treaty permits the imposition of a branch profits tax, but limits the rate of such tax to 15 percent. In the case of Turkey, source country tax may be imposed on the profits that are attributable to a permanent establishment in Turkey and that remain after payment of the Turkish corporate tax pursuant to the provisions of Article 7 (Business Profits). In the case of the United States, the branch profits tax may be imposed on a Turkish corporation that either has a permanent establishment in the United States or is subject to net-basis U.S. tax on income from real property or gains from the disposition of real property interests. Such tax may be imposed only on the portion of the business profits attributable to such permanent establishment, or the portion of such real property income or gains, that represents the "dividend equivalent amount." The Technical Explanation states that the term "dividend equivalent amount" was understood to refer to Code section 884(b) (as it may be amended).

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 dividends are attributable to the permanent establishment. Dividends attrib-

utable to a permanent establishment are taxed as business profits (Article 7). The proposed treaty's reduced rates of tax on dividends also do not apply if the dividend recipient is a Turkish resident who performs independent personal services in the United States from a fixed base located in the United States and such dividends are attributable to the fixed base. In such a case, the dividends attributable to the fixed base are taxed as income from the performance of independent personal services (Article 14). Under the proposed protocol, these rules also apply if the permanent establishment or fixed base no longer exists when the dividends are paid but such dividends are attributable to the former permanent establishment or fixed base.

The proposed treaty contains a general limitation on the taxation by a treaty country of dividends paid to a resident of the other country by a corporation that is not a resident of the first country (a so-called "second-level withholding tax"). Under this provision, a treaty country may not impose any tax on dividends paid by a corporation that is resident in the other country except where the dividends are paid to a resident of the first country, or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or fixed base of the recipient in the first country.

Article 11. Interest

Internal taxation rules

United States

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

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

If an investor holds an interest in a fixed pool of real estate mortgages that is a real estate mortgage interest conduit ("REMIC"), the REMIC generally is treated for U.S. tax purposes

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

Turkey

Turkey generally imposes a withholding tax on Turkish-source interest paid to nonresidents of Turkey at a rate of 5 or 10 percent. Turkey also levies a 10-percent surtax on such withholding tax.

Proposed treaty limitations on internal law

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

The proposed treaty limits the rate of source country tax that may be imposed on interest income. Under the proposed treaty, if the beneficial owner of interest is a resident of the other country, the source country tax on such interest generally may not exceed 15 percent of the gross amount of such interest. This rate is higher than the rate permitted under most other U.S. income tax treaties. In the case of interest derived from any type of loan granted by a financial institution such as a bank, savings institution, or insurance company, the rate of source country tax may not exceed 10 percent of the gross amount of such interest.

The proposed treaty provides for a complete exemption from source country withholding tax in the case of certain categories of interest earned by residents of the other country. Interest arising in the United States and paid to the Government of Turkey or the Central Bank of Turkey (Turkiye Cumhuriyet Merkez Bankasi) is exempt from U.S. tax. Similarly, interest arising in Turkey and paid to the Government of the United States or any Federal Reserve Bank is exempt from Turkish tax. Moreover, interest arising in either country in connection with a debt obligation that is guaranteed or insured by the government of the other country is exempt from source country tax. The proposed treaty provides that the competent authorities will by mutual agreement determine the scope of this third exemption rule. The Technical Explanation states that it is understood that this third exemption refers to loans guaranteed or insured by U.S. institutions such as the Export-Import Bank and the Overseas Private Investment Corporation.

The proposed treaty defines the term "interest" as income from debt claims of every kind, whether or not secured by a mortgage and whether or not carrying a right to participate in the debtor's

profits. In particular, it includes income from government securities and from bonds or debentures, including premiums or prizes attaching to such securities, bonds, or debentures. The proposed treaty includes in the definition of interest any other income that is treated as income from money lent by the domestic law of the country in which the income arises. The proposed treaty provides that the term "interest" does not include amounts treated as dividends under Article 10 (Dividends).

The proposed treaty does not exclude from the definition of interest penalty charges for late payments. The Technical Explanation states that such payments are regarded as interest under Turkish law and will be taxable in Turkey (subject to the limitations of this article).

In the case of the United States, the term "interest" includes the excess of (1) the amount of interest borne by a permanent establishment, fixed base, or trade or business subject to tax on a net basis with respect to real property income or gains, over (2) the interest paid by that permanent establishment, fixed base or trade or business in the United States. This rule allows the United States to impose its branch-level excess interest tax; however, such tax may be imposed only at the treaty rate applicable to interest payments.

The proposed treaty's reductions in source country tax on interest do not apply if the beneficial owner carries on business in the source country through a permanent establishment located in that country and the interest is attributable to that permanent establishment. In such an event, the interest is taxed as business profits (Article 7). The proposed treaty's reduced rates of tax on interest also do not apply if the interest recipient is a Turkish resident who performs independent personal services in the United States from a fixed base located in the United States and such interest is attributable to the fixed base. In such a case, the interest attributable to the fixed base is taxed as income from the performance of independent personal services (Article 14). Under the proposed protocol, these rules also apply if the permanent establishment or fixed base no longer exists when the interest is paid but such interest is attributable to the former permanent establishment or fixed base.

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

The proposed treaty provides that the reductions in and exemption from source country tax do not apply to excess inclusions with respect to a U.S. REMIC. Such income may be taxed in accordance with U.S. internal law. The proposed treaty also provides that such

reductions and exemption do not apply to contingent interest of a type that does not qualify as portfolio interest under U.S. law and to equivalent amounts under Turkish law. Such contingent interest is taxed under Article 10 (Dividends) as if it were a dividend. The proposed protocol provides that it is understood that the term "contingent interest" will be defined in accordance with sections 871(h)(4) and 881(c)(4) of the Code when such interest arises in the United States.

The proposed treaty provides that interest is treated as arising in a country if the payor is that country, including its political subdivisions and local authorities, or a resident of that country.⁵ If, however, the interest expense is borne by a permanent establishment or a fixed base or a trade or business subject to net-basis tax on real property income or gains in a treaty country, the interest would have as its source the country in which the permanent establishment, fixed base, or trade or business is located, regardless of the residence of the payor. Thus, for example, if a French resident has a permanent establishment in Turkey and that French resident incurs indebtedness to a U.S. person, the interest on which is borne by the Turkish permanent establishment, the interest would be treated as having its source in Turkey.

Article 12. Royalties

Internal taxation rules

United States

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

Turkey

Turkey generally imposes a withholding tax of 25 percent on royalties derived by nonresidents. Turkey also levies a 10-percent surtax on such withholding tax.

Proposed treaty limitations on internal law

The proposed treaty provides that royalties arising in a treaty country paid to a resident of the other country may be taxed by that other country. In addition, the proposed treaty allows the country where the royalties arise (the "source country") to tax such royalties. However, if the beneficial owner of the royalties is a resident of the other country, the source country tax generally may not exceed 10 percent of the gross royalties. This 10-percent rate is higher than the rate permitted under most U.S. treaties and the U.S. and OECD models. The U.S. and OECD models generally exempt royalties from source country taxation.

For purposes of this 10-percent limitation, the term "royalties" means payment of any kind received as consideration for the use of, the right to use, or the sale (which is contingent on the produc-

⁵This is consistent with the source rules of U.S. law, which provide as a general rule that interest income has as its source the country in which the payor is resident.

tivity, use, or disposition) of any copyright of literary, artistic, or scientific work, patent, trademark, design or model, plan, secret formula or process. The term also includes consideration for information concerning industrial, commercial or scientific experience. In addition, the term includes royalties in respect of motion pictures and works on film, tape or other means of reproduction for use in connection with radio or television broadcasting. According to the Technical Explanation, it is understood that whether payments with respect to computer software are treated as royalties (or as business profits) will depend on the facts and circumstances of the particular transaction. The Technical Explanation also states that it is understood that payments with respect to transfers of "shrink wrap" computer software will be treated as business profits.

The proposed treaty further provides that the source country tax on certain amounts treated as royalties may not exceed 5 percent of the gross royalties. This 5-percent limitation applies to payments of any kind in consideration for the use, or the right to use, industrial, commercial, or scientific equipment.

These reduced rates apply only if the royalty is beneficially owned by a resident of the other country; they do not apply if the recipient of the royalty is a nominee for a nonresident.

In addition, the reduced rates do not apply where the recipient is an enterprise that carries on business through a permanent establishment in the source country, and the royalties are attributable to the permanent establishment. In that event, the royalties are taxed as business profits (Article 7). The proposed treaty's reduced rates of tax on royalties also do not apply if the recipient is a Turkish resident who performs independent personal services in the United States from a fixed base located in the United States and such royalties are attributable to the fixed base. In such a case, the royalties attributable to the fixed base are taxed as income from the performance of independent personal services (Article 14). Under the proposed protocol, these rules also apply if the permanent establishment or fixed base no longer exists when the royalties are paid but such royalties are attributable to the former permanent establishment or fixed base.

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

The proposed treaty provides source rules for royalties which differ, in part, from those provided under U.S. internal law. Royalties are deemed to arise within a country if the payor is that country, including its political subdivisions and local authorities, or a resident of that country. If, however, the royalty expense is borne by a permanent establishment (or fixed base) that the payor has in

Turkey or the United States, the royalty has as its source the country in which the permanent establishment (or fixed base) is located, regardless of the residence of the payor. Thus, for example, if a French resident has a permanent establishment in Turkey and that French resident pays a royalty to a U.S. person which is attributable to the Turkish permanent establishment, then the royalty would be treated as having its source in Turkey. In addition, the proposed treaty provides that where the preceding rules do not operate to deem royalties as arising in either the United States or Turkey, and the royalties relate to the use of, or the right to use, a right or property in one of those countries, the royalties are deemed to arise in that country.

Article 13. Gains

Internal taxation rules

United States

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

Turkey

Under Turkish law, gains from the sale of a capital asset by a foreign corporation or a nonresident individual may be subject to Turkish tax. Gains of a foreign corporation constitute business income that are taxed in the same manner as other business income. Certain exemptions from the tax on gains that are available to Turkish corporations and resident individuals are not applicable to foreign corporations and nonresident individuals.

Proposed treaty limitations on internal law

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

Under the proposed treaty, gains derived by a resident of one treaty country from the alienation of real property situated in the other country may be taxed in the country where the property is situated. In addition, gains derived by a resident of one country from the alienation of an interest in a partnership, trust, or estate, to the extent attributable to real property situated in the other country, may be taxed in the country where the property is situated. For the purposes of this article, real property in the other country includes (1) real property as defined in Article 6 (Income for Immovable Property (Real Property)) situated in the other country, (2) an interest in a partnership, trust, or estate, to the extent

that its assets consist of real property situated in that other country, and (3) a U.S. real property interest or an equivalent interest in Turkish real estate.

Gains from the alienation of movable property that forms a part of the business property of a permanent establishment which an enterprise of one country has in the other country, gains from the alienation of movable property pertaining to a fixed base which is available to a resident of one country in the other country for the purpose of performing independent personal services, and gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or such a fixed base, may be taxed in that other country. Under the proposed protocol, this rule also applies if the permanent establishment or fixed base no longer exists when the gains are recognized but such gains relate to the former permanent establishment or fixed base.

Gains from the alienation of ships, aircraft, or containers operated in international traffic, (or movable property pertaining to the operation of ships, aircraft, or containers) are taxable only in the country in which the person disposing of such property is resident.

Gains from the alienation of any other property is taxable under the proposed treaty only in the country where the person disposing of the property is resident. However, the proposed treaty provides an exception to this general rule. Under this exception, a treaty country, in accordance with its internal law, may tax gains derived by a resident of the other country from the alienation of shares or bonds issued by a company that is resident in the first country if three conditions are met. First, the shares or bonds must not be listed on a stock exchange in the first country. Second, the shares or bonds must be alienated to a resident of the first country. Third, the person who is alienating such shares or bonds must have held them for one year or less. This exception was included at the request of Turkey; the United States does not impose U.S. tax on gains of foreign persons under such circumstances.

Article 14. Independent Personal Services

Internal taxation rules

United States

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

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

Turkey

Nonresident individuals generally are subject to Turkish withholding tax at a rate of 10 or 20 percent on Turkish source income with respect to the performance of professional services. Turkey also levies a 10 percent surtax on such withholding tax.

Proposed treaty limitations on internal law

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

Under the proposed treaty, income in respect of professional services or other activities of an independent character performed in one country by a resident of the other country is exempt from tax in the country where the services are performed (the source country) unless the individual performing the services crosses either of two thresholds in the source country. The individual may be taxed in the source country if he or she has a fixed base regularly available to him or her in that country for the purpose of performing the services.⁶ In that case, the source country is permitted to tax only that portion of the individual's income which is attributable to the fixed base. In addition, if the individual is present in the source country for the purpose of performing the services for a period or periods exceeding 183 days within a twelve-month period, the source country is permitted to tax the income derived from the performance of services in that country during that period. This latter rule represents a departure from the U.S. model, which would permit the source country to tax the income from independent personal services of a resident of the other country only if the income is attributable to a fixed base regularly available to the individual in the source country for the purpose of performing the activities.

The Technical Explanation states that it is understood that the rules of Article 7 (Business Profits) for attributing income and expenses to a permanent establishment are relevant for attributing income to a fixed base; in particular, such income must be taxed on a net basis.

The proposed treaty also provides that income derived by an enterprise of one country in respect of professional services or other activities of a similar character performed in the other country may be taxed in the source country if the enterprise has a permanent establishment in the source country through which such services are performed or the periods during which such services are performed exceed 183 days in any twelve-month period. In such cases, the source country is permitted to tax only the income that is attributable to the permanent establishment or to the services performed in the source country, as the case may be. The proposed treaty provides that Turkey may levy a withholding tax on such income. However, the proposed treaty further provides that the en-

⁶ According to the Technical Explanation, it is understood that the concept of a fixed base is analogous to the concept of a permanent establishment.

terprise may elect to be taxed on such income on a net basis, in accordance with the provisions of Article 7 (Business Profits).

Article 15. Dependent Personal Services

Under the proposed treaty, wages, salaries, and other similar remuneration derived from services performed as an employee in one country (the source country) by a resident of the other country are taxable only by the country of residence if three requirements are met: (1) the individual must be present in the source country for not more than 183 days in any twelve-month period; (2) his or her employer must not be a resident of the source country; and (3) the compensation must not be borne by a permanent establishment or fixed base of the employer in the source country. These limitations on source country taxation are similar to the rules of the U.S. model and the OECD model.

The proposed treaty contains a special rule that permits remuneration derived by a resident of one country in respect of employment as a member of the crew of a ship or aircraft operated in international traffic by an enterprise of the other country to be taxed in that other country. A similar rule is included in the OECD model. U.S. internal law does not impose tax on such income of a nonresident alien, even if such person is employed by a U.S. entity.

This article is subject to the provisions of the separate articles covering directors' fees (Article 16), pensions and annuities (Article 18), government service income (Article 19), and income of students and teachers (Article 20).

Article 16. Directors' Fees

Under the proposed treaty, directors' fees and other similar payments derived by a resident of one country for services rendered in the other country as a member of the board of directors of a company which is a resident of that other country is taxable in that other country. Under the proposed treaty, as under the U.S. model, the country where the director resides continues to have sole taxing jurisdiction over remuneration derived from services performed outside the other country.

Article 17. Artistes and Athletes

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

Under the proposed treaty, income derived by an entertainer or athlete who is a resident of one country from his or her personal activities as such in the other country may be taxed in the other country if the amount of the gross receipts derived by him or her from such activities exceeds \$3,000 or its Turkish currency equivalent. The Technical Explanation states that the \$3,000 threshold does not include reimbursed expenses. Under this rule, if a Turkish

entertainer or athlete maintains no fixed base in the United States and performs (as an independent contractor) for one day of a taxable year in the United States for total compensation of \$2,000, the United States could not tax that income. If, however, that entertainer's or athlete's total compensation were \$4,000, the full amount would be subject to U.S. tax.

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

The proposed treaty provides that these rules do not apply to income derived from activities performed in a country by entertainers or athletes if such activities are substantially supported by a non-profit organization of the other country or by public funds of the other country or a political subdivision or a local authority thereof.

Article 18. Pensions and Annuities

Under the proposed treaty, pensions and other similar remuneration paid to a resident of either country in consideration of past employment, whether paid periodically or in a lump sum, is subject to tax only in the recipient's country of residence. In contrast, the proposed treaty provides that payments made by one of the countries under the provisions of the social security or similar legislation of the country to a resident of the other country or to a U.S. citizen are taxable by the source country, but not by the country of residence. The Technical Explanation states that the term "similar legislation" is intended to include U.S. tier 1 Railroad Retirement benefits. Consistent with the U.S. model, this rule with respect to social security payments is an exception to the proposed treaty's saving clause. These rules are subject to the provisions of Article 19 (Government Service) with respect to pensions.

The proposed treaty also provides that annuities are taxed only in the country of residence of the individual who beneficially owns and derives them. 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, under an obligation to make the payments in return for adequate and full consideration (other than services rendered).

Article 19. Government Service

Under the proposed treaty, remuneration, other than a pension, paid by one of the countries (or a political subdivision or local au-

thority thereof) to an individual in respect of services rendered to that country (or subdivision or authority) generally is taxable only by that country. Such remuneration is taxable only in the other country, however, if the services are rendered in that other country by an individual who is a resident of that country and who (1) is also a national of that country or (2) did not become a resident of that country solely for the purpose of rendering the services. This treatment is similar to the rules under the U.S. and OECD models.

The proposed treaty further provides that any pension paid by, or out of funds created by, one of the countries (or a political subdivision or local authority thereof) to an individual in respect of services rendered to that country (or subdivision or authority) is taxable only by that country. Such a pension is taxable only by the other country, however, if the individual is a national and resident of that other country. This treatment is similar to the rules under the U.S. and OECD models.

The provisions described in the foregoing paragraphs are exceptions to the proposed treaty's saving clause for individuals who are neither citizens nor permanent residents of the country where the services are performed. Thus, for example, payments by the government of Turkey to its employees in the United States are exempt from U.S. tax if the employees are not U.S. citizens or green card holders and were not residents of the United States at the time they became employed by the Turkish government.

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

Article 20. Students, Apprentices, and Teachers

Under the proposed treaty, a student, apprentice, or business trainee who is, or was immediately before visiting the host country, a resident of the other country, and who is present in the host country for the purpose of his or her full-time education or training,⁷ is not taxable in the host country on payments received for the purpose of education or training, provided the payments arise outside of the host country. The U.S. and OECD models also provide for some host-country exemptions for students and trainees. The U.S. model differs from the proposed treaty and the OECD model by providing a time limit for such exemption.

Under the proposed treaty, a teacher or instructor who is, or was immediately before visiting the host country, a resident of the other country and who is present in the host country for the purpose of teaching or engaging in scientific research is not taxable in the host country on his or her remuneration from personal services for teaching or research, provided such remuneration arises outside the host country. However, this rule applies only if the individual

⁷ According to the Technical Explanation, use of the word "full-time" in the proposed treaty is not intended to exclude students or trainees who, in accordance with their visas, are also employed in the host country. Such person will still be entitled to exemption from host country tax so long as he or she participates in a full-time program of study or training.

is present in the host country for a period or periods not exceeding two years.

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

Article 21. Other Income

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

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

The general rule just stated does not apply to income (other than income from real property as defined in Article 6) if the beneficial owner of the income is a resident of one country and carries on business in the other country through a permanent establishment, or performs services in the other country from a fixed base, and the income is attributable to such permanent establishment or fixed base. In such a case, the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, will apply. Under the proposed protocol, such exception also applies where the income is received after the permanent establishment or fixed base is no longer in existence, but the income is attributable to the former permanent establishment or fixed base.

Article 22. Limitation on Benefits

In general

The proposed treaty contains a provision generally intended to limit the indirect use of the proposed treaty by persons who are not entitled to its benefits by reason of residence in the United States or Turkey.

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

ties, or other amounts under favorable conditions either through relaxed tax provisions in the distributing country or by passing the funds through other treaty countries until the funds can be repatriated under favorable terms.

The proposed anti-treaty shopping article provides that a person other than an individual that is a resident of either Turkey or the United States and that derives income from the other treaty country is not entitled to the benefits of the treaty unless one of the following requirements is satisfied:

(1) the resident is one of the treaty countries or a political subdivision or local authority thereof;

(2) the income derived by the resident from the other country is derived by a not-for-profit organization that meets specified conditions;

(3) the resident is a company that meets one of two public company tests;

(4) the resident meets an ownership and base erosion test;

or

(5) the resident meets an active business test.

In addition, a person that does not satisfy any of the above requirements may be granted the benefits of the proposed treaty if the competent authority of the country in which the income in question arises so determines.

Tax-exempt entities

An entity is entitled to benefits under the proposed treaty if it is a not-for-profit organization that, by virtue of that status, generally is exempt from income taxation in its treaty country of residence, provided that more than half of its annual support is expended for the benefit of "qualified persons" or is derived from "qualified persons." For this purpose, a "qualified person" is a citizen of the United States or a person (including an individual) that qualifies for the benefits of the proposed treaty, but not by reason of the active business test. The U.S. model does not contain a similar support test.

Public company tests

Under the public company tests, a company that is a resident of Turkey or the United States and that has substantial and regular trading in its principal class of shares on a recognized stock exchange is entitled to the benefits of the treaty regardless of where its actual owners reside or the amount or destination of payments it makes. Similarly, treaty benefits are available to a company that is wholly owned (directly or indirectly) by a company that satisfies the public company test just described, provided that each company in the chain of ownership used to satisfy the control requirements is a resident of Turkey or the United States. These rules are similar, but not identical, to the corresponding rules in the U.S. model.

The term "recognized securities exchange" means the NASDAQ System owned by the National Association of Securities Dealers, Inc.; any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for the purposes of the Securities Exchange Act of 1934; the Istanbul Stock

Exchange; and any other stock exchange agreed upon by the competent authorities of the two countries.

Ownership and base erosion tests

Under the ownership test, more than 50 percent of the beneficial interest in an entity (or, in the case of a company, more than 50 percent of the number of shares of each class of the company's shares) must be owned, directly or indirectly, by one or more individual residents of Turkey or the United States, citizens of the United States, certain publicly traded companies (as described in the discussion of the public company tests above), the countries themselves, political subdivisions or local authorities of the countries, or certain tax-exempt organizations (as described in the discussion of tax-exempt entities above). This rule could, for example, deny the benefits of the reduced U.S. withholding tax rates on dividends and royalties paid to a Turkish company that is controlled by individual residents of a third country. The more-than-50-percent ownership threshold in the proposed treaty is slightly more stringent than the at-least-50-percent ownership threshold in the U.S. model.

In addition, the base erosion test is met only if the income of the entity is not used in substantial part, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons or entities other than those referred to in the preceding paragraph. This rule is intended to prevent a corporation, for example, from distributing most of its income, in the form of deductible items such as interest, royalties, service fees, or other amounts) to persons not entitled to benefits under the proposed treaty. Unlike the U.S. model, the proposed treaty does not specify a percentage of the company's gross income that cannot be paid to non-qualifying persons.

Active business test

Under the active business test, treaty benefits are available under the proposed treaty to an entity that is a resident of one of the treaty countries with respect to income from the other country if the entity is engaged in the active conduct of a trade or business in its residence country and the income is derived in connection with, or is incidental to, that trade or business. However, this does not apply (and benefits therefore may be denied) to the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company. In the case of income derived in connection with the active trade or business, such trade or business in its residence country must be substantial in relation to the activity in the other country from which it derives the income for which it is claiming treaty benefits. Under the U.S. model, the trade or business in the residence country must also be "substantial" in cases where the income derived by the source country is "incidental" to the trade or business of the residence country. The proposed treaty does not apply a substantiality test to such incidental income.

The Technical Explanation provides that income is considered derived in connection with an active trade or business in the United States if, for example, the income generating activity in the United

States is upstream, downstream, or parallel to that conducted in Turkey. The Technical Explanation further provides that income is considered incidental to a Turkish trade or business if it arises from the short-term investment of working capital of the Turkish resident in U.S. securities. The proposed treaty does not define whether a trade or business is "substantial." The Technical Explanation states that to be considered substantial, it is not necessary, for example, that a trade or business in Turkey be as large as the U.S. income-generating activity. However, the Turkish trade or business cannot be, in terms of income, assets, or similar measures, only a very small percentage of the size of the U.S. activity.

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

Grant of treaty benefits by the competent authority

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

Article 23. Relief from Double Taxation

Internal taxation rules

United States

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

Turkey

Turkey taxes the worldwide income of Turkish corporations and resident individuals. Turkey generally provides relief from double taxation by allowing taxpayers to credit foreign taxes paid on foreign income against Turkish tax payable. The total credit generally may not exceed the Turkish tax that would be payable with respect to such income. Foreign tax credits generally are calculated separately with respect to each source of income from each country.

Proposed treaty limitations on internal law

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

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

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

The proposed protocol provides that a credit will be allowed against the alternative minimum tax ("AMT") for taxes paid to Turkey, provided that such credit may not offset more than 90 percent of the AMT. Foreign tax credits that are unused because of this 90-percent limitation may be carried forward and backward against other years' AMT liability. If under U.S. law the 90-percent limitation is increased, such increased limitation will apply for purposes of the proposed treaty.

The proposed treaty provides that the Turkish taxes referred to in Article 2 (Taxes Covered) are considered income taxes for purposes of the foregoing rules regarding the U.S. foreign tax credit. The proposed protocol provides that, for purposes of this article, the withholding tax under Article 94 of Turkey's Income Tax Law is not considered an income tax. Such tax is imposed on certain progress payments with respect to construction contracts. Whether such tax is creditable for U.S. tax purposes depends upon whether

it meets the U. S. internal law standards. The Technical Explanation states that issues exist with respect to the application of such standards to this tax.

The proposed treaty generally provides that Turkey will allow residents of Turkey, who derive income that may be subject to tax in the United States and Turkey, a deduction against Turkish income tax for the U.S. income taxes paid. The allowance of this reduction is subject to the provisions of Turkish tax law regarding credit for foreign taxes (as such law may be amended from time to time without changing the general principles of this treaty provision). The reduction will not exceed the pre-credit amount of Turkish income tax appropriate to the income that may be taxed in the United States.

For purposes of implementing the proposed treaty's foreign tax credit, the proposed treaty provides a source rule for determining the country in which an item of income is deemed to have arisen. Under this rule, income derived by a resident of one of the countries that may be taxed in the other country in accordance with the proposed treaty (other than solely by reason of citizenship) is treated as arising in that other country. However, the preceding rule does not override the source rules of the domestic laws of countries that are applicable for purposes of limiting the foreign tax credit.

Article 24. Non-Discrimination

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

In general, under the proposed treaty, one country could not discriminate by imposing other or more burdensome taxes (or requirements connected with taxes) on nationals of the other country than it would impose on its nationals in the same circumstances. This provision applies whether or not the nationals in question are residents of the United States or Turkey.

Under the proposed treaty, neither country may tax a permanent establishment of an enterprise of the other country less favorably than it taxes its own enterprises carrying on the same activities. Consistent with the U.S. model and the OECD model, however, a country is not obligated to grant residents of the other country any personal allowances, reliefs, or reductions for tax purposes on account of civil status or family responsibilities which it grants to its own residents.

The proposed treaty explicitly provides that nothing in the non-discrimination article is to be construed as preventing either of the countries from imposing a branch profits tax or a branch-level interest tax.

Each country is required (subject to the arm's-length pricing rules of Articles 9 (Associated Enterprises), 11 (Interest), and 12 (Royalties)) to allow its residents to deduct interest, royalties, and other disbursements paid by them to residents of the other country under the same conditions that it allows deductions for such amounts paid to residents of the same country as the payor. The Technical Explanation states that the term "other disbursements"

is understood to include a reasonable allocation of executive and general administrative expenses, research and development expenses, and other expenses incurred for the benefit of a group of related persons. The Technical Explanation further states that the so-called "earnings-stripping" rules of section 163(j) of the Code are not discriminatory within the meaning of this provision.

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

The saving clause (which allows the country of residence or citizenship to impose tax notwithstanding certain treaty provisions) does not apply to the nondiscrimination article.

Article 25. Mutual Agreement Procedure

The proposed treaty contains the standard mutual agreement provision, with some variation, that authorizes the competent authorities of the two countries to consult together to attempt to alleviate individual cases of double taxation not in accordance with the proposed treaty. The saving clause of the proposed treaty does not apply to this article, so that the application of this article might result in a waiver (otherwise mandated by the proposed treaty) of taxing jurisdiction by the country of citizenship or residence.

Under this article, a resident of one country who considers that the action of one or both of the countries will cause him or her to be subject to tax which is not in accordance with the proposed treaty may present his or her case to the competent authority of the country of which he or she is a resident or national. The competent authority then makes a determination as to whether the objection appears justified. If the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, that competent authority endeavors to resolve the case by mutual agreement with the competent authority of the other country, with a view to the avoidance of taxation which is not in accordance with the proposed treaty. The provision authorizes a waiver of the statute of limitations of either country, provided that the competent authority of the other country received notification of the case within five years of the end of the taxable year to which the case relates.

The proposed protocol provides that if a taxpayer is entitled to a refund from Turkey as a result of the mutual agreement procedures described above, the taxpayer must claim the refund within one year after the taxpayer has been notified by the tax administration of the results of such procedures.

The competent authorities of the countries must 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 attribution of income, deductions, credits, or allowances of an enterprise of one treaty country to the enterprise's permanent establishment in the other country; (2) the allocation of income, deductions, credits, or allowances between persons; (3) the characterization of particular items of income; (4) the application of source rules with respect to particular items of income; (5) a common meaning of a term; (6) increases in specific dollar thresholds in the proposed treaty to reflect economic or monetary developments; and (7) the application of provisions of each country's internal law regarding penalties, fines, and interest in a manner consistent with the purposes of the proposed treaty. The competent authorities may also consult together for the elimination of double taxation regarding cases not provided for in the proposed treaty. This treatment is similar to the treatment under the U.S. model.

The proposed 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. This provision makes clear that it is not necessary to go through diplomatic channels in order to discuss problems arising in the application of the proposed treaty.

Article 26. Exchange of Information

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

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

Any information exchanged under the proposed treaty will be treated as secret in the same manner as information obtained under the domestic laws of the country receiving the information. The exchanged information may be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration, enforcement, or prosecution in respect of, or the determination of appeals in relation to, the taxes to which the proposed treaty would apply. Such persons or authorities may use the information for such purposes only.⁸ The Technical Explanation states that persons involved in the administration of taxes include legislative bodies with oversight roles with respect to the administration of the tax laws, such as, for ex-

⁸ Code section 6103 provides that otherwise confidential tax information may be utilized for a number of specifically enumerated non-tax purposes. Information obtained by the United States pursuant to the proposed treaty could not be used for these non-tax purposes.

ample, the tax-writing committees of Congress and the General Accounting Office. Exchanged information may be disclosed in public court proceedings or in judicial decisions.

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

The proposed treaty provides that upon an appropriate request for information, the requested country will obtain the information to which the request relates in the same manner and to the same extent as if the tax were its own tax. If specifically requested by the competent authority of a country, the competent authority of the other country will provide requested information in a form consistent with the purposes of the request to the maximum extent possible under its laws and administrative practices and procedures.

Article 27. Members of Diplomatic Missions and Consular Posts

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

Article 28. Entry Into Force

The proposed treaty will enter into force on the date the instruments of ratification are exchanged.

With respect to taxes withheld at source, the proposed treaty will be effective for amounts paid or credited on or after the first day of January next following the date on which the proposed treaty enters into force.

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

Article 29. Termination

The proposed treaty will continue in force until terminated by either country. Either country may terminate the proposed treaty at any time after the expiration of the five-year period from the date of its entry into force, provided that at least six months prior notice of termination has been given through diplomatic channels. A ter-

mination is effective, with respect to taxes withheld at source for amounts paid or credited on or after the first day of January next following the expiration of the notification period. In the case of other taxes, a termination is effective for taxable periods beginning on or after the first day of January next following the expiration of the notification period.

IV. ISSUES

The proposed treaty with Turkey, as supplemented by the proposed protocol, presents the following specific issues.

A. Treatment of REIT Dividends

REITs in general

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

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

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

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

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

In order to satisfy the source of income requirements, at least 95 percent of the gross income of the REIT generally must be from

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

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

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

Foreign investors in REITs

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

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

U.S. income tax treaties contain provisions limiting the amount of income tax that may be imposed by one country on residents of the other country. Many treaties, like the proposed treaty, generally allow the source country to impose not more than a 15-percent withholding tax on dividends paid to a resident of the other treaty country. In the case of real estate income, most treaties, like the proposed treaty, specify that income derived from, and gain from dispositions of, real property in one country may be taxed by the country in which the real property is situated without limitation.⁹ Accordingly, U.S. real property rental income derived by a resident of a treaty partner generally is subject to the U.S. withholding tax at the full 30-percent rate (unless the net-basis taxation election is made), and U.S. real property gains of a treaty partner resident are subject to U.S. tax in the manner and at the rates applicable to U.S. persons.

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

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

Beginning in 1989, U.S. treaty negotiators began including in treaties provisions excluding REIT dividends from the reduced rates of withholding tax generally applicable to dividends. Under treaties with these provisions such as the proposed treaty, REIT dividends generally are subject to the full U.S. 30-percent withholding tax.¹⁰

Analysis of treaty treatment of REIT dividends

The specific treaty provisions governing REIT dividends were introduced beginning in 1989 because of concerns that the reductions in withholding tax generally applicable to dividends were inappropriate in the case of dividends from REITs. The reductions in the rates of source country tax on dividends reflect the view that the

⁹The proposed treaty, like many treaties, allows the foreign person to elect to be taxed in the source country on income derived from real property on a net basis under the source country's domestic laws.

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

full 30-percent withholding tax rate may represent an excessive rate of source country taxation where the source country already has imposed a corporate-level tax on the income prior to its distribution to the shareholders in the form of a dividend. In the case of dividends from a REIT, however, the income generally is not subject to corporate-level taxation.

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

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

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

This argument is premised on the view that investment in a REIT is not equivalent to direct investment in real property. From this perspective, an investment in a REIT should be viewed as comparable to other investments in corporate stock. In this regard, like other corporate shareholders, REIT investors are investing in the management of the REIT and not just its underlying assets. Moreover, because the interests in a REIT are widely held and the REIT itself typically holds a large and diversified asset portfolio, an investment in a REIT represents a very small investment in each of a large number of properties. Thus, the REIT investment provides diversification and risk reduction that are not easily replicated through direct investment in real estate.

Issue

Under many older U.S. tax treaties, the U.S. withholding tax on REIT dividends paid to residents of the treaty partner is limited to a maximum rate of 15 percent. Under the proposed treaty, as

under recent U.S. tax treaties, the reduced rates of U.S. withholding applicable to dividends generally do not apply to REIT dividends and, thus, REIT dividends paid to residents of Turkey may be subject to U.S. withholding tax at the full statutory rate of 30 percent. The Committee may wish to consider whether, in light of the competing considerations discussed above, the treatment of REIT dividends in the proposed treaty is appropriate.

B. Developing Country Concessions

The proposed treaty contains a number of developing country concessions, some of which are found in other U.S. income tax treaties with developing countries. The most significant of these concessions are described below.

Definition of permanent establishment

The proposed treaty departs from the U.S. and OECD models by providing for broader source-basis taxation with respect to business activities. The proposed treaty's permanent establishment article, for example, permits the country in which business activities are carried on to tax the activities in circumstances where it would not be able to do so under either of the model treaties. Under the proposed treaty, a building site or construction, assembly or installation project in a treaty country constitutes a permanent establishment if the site or project continues in a country for more than six months; under the U.S. and OECD models, such a site or project must last for more than one year in order to constitute a permanent establishment. Thus, for example, under the proposed treaty, a U.S. enterprise's business profits that are attributable to a construction project in Turkey will be taxable by Turkey if the project lasts for more than six months. In addition, under the proposed protocol, the use of an installation or drilling rig or ship for the exploration or exploitation of natural resources in a country for more than 183 days in any twelve-month period would cause such rig or ship to be treated in a manner analogous to a permanent establishment. Under the U.S. model, drilling rigs or ships must be present in a country for more than one year in order to constitute a permanent establishment. It should be noted that many tax treaties between the United States and developing countries similarly provide a permanent establishment threshold of six months for building sites and drilling rigs.

The proposed treaty contains a provision, not present in either the U.S. model or the OECD model, which expands the circumstances under which activities of dependent agents will give rise to a permanent establishment. Under this provision, an enterprise of one treaty country is treated as having a permanent establishment in the other country if its dependent agent habitually maintains in the other country a stock of goods or merchandise from which the agent regularly makes deliveries on behalf of the enterprise. However, this rule applies only if it is proved that in order to avoid tax in such country the agent also undertakes virtually all the activities connected with the sale of such goods or merchandise (except for the actual conclusion of the sales contract).

Taxation of business profits

Under the U.S. model and many other U.S. income tax treaties, a country may only tax the business profits of a resident of the other country to the extent those profits are attributable to a permanent establishment situated within the first country. The proposed protocol expands the definition of business profits that are attributable to a permanent establishment to include profits that are derived from sales of goods or merchandise of the same or similar kind as those sold through the permanent establishment and profits derived from other business activities of the same or similar kind as those effected through the permanent establishment. However, this rule applies only if it is proved that the sale or activities were structured in a manner intended to avoid tax in the country where the permanent establishment is located. This expanded definition is narrower than the rule included in other U.S. tax treaties with developing countries. It should be noted that although this rule provides for broader source basis taxation than does the rule contained in the U.S. model, it is not as broad as the general "force of attraction" rule that is included in the Code.

Taxation of certain equipment leasing

The proposed treaty treats as royalties payments for the use of, or the right to use, industrial, commercial, or scientific equipment. In most other treaties, these payments are considered rental income; as such, the payments are subject to the business profits rules, which generally permit the source country to tax such amounts only if they are attributable to a permanent establishment located in that country, and the payments are taxed, if at all, on a net basis. By contrast, the proposed treaty permits gross-basis source country taxation of these payments, at a rate not to exceed 5 percent, if the payments are not attributable to a permanent establishment situated in that country. If the payments are attributable to such a permanent establishment, the business profits article of the proposed treaty is applicable.

Other taxation by source country

The proposed treaty includes a number of additional concessions with respect to source basis taxation of amounts earned by residents of the other treaty country.

The proposed treaty allows a maximum rate of source country tax on dividends of 20 percent (15 percent if the beneficial owner of the dividend is a company that owns at least 10 percent of the voting shares of the payor). These maximum rates on dividends are higher than those provided in either the U.S. model or the OECD model.

The proposed treaty allows a maximum rate of source country tax on interest of 15 percent (10 percent in the case of interest on a loan granted by a financial institution). The proposed treaty provides an exemption from source country tax for interest paid to the government of each country and to certain governmental entities. It should be noted that the maximum rates are higher than the rates of withholding tax on interest under Turkish law currently. By contrast, the U.S. model generally would not permit source country taxation of interest. Moreover, the maximum rate per-

mitted under the proposed treaty is higher than the maximum rate provided in the OECD model.

The proposed treaty allows a maximum rate of source country tax on royalties of 10 percent (5 percent in the case of income from the use of certain equipment as discussed above). By contrast, both the U.S. model and the OECD model generally would not permit source country taxation of royalties.

The proposed treaty permits source country taxation of income derived by a resident of the other treaty country from professional or other independent services if the resident is present in the source country for the purpose of performing such services for more than 183 days in any 12-month period. Similarly, the proposed treaty permits source country taxation of income derived by an enterprise of the other treaty country from professional or other independent services if the period or periods during which such services are performed exceed 183 days in any 12-month period. By contrast, the U.S. and OECD models generally would permit source country taxation of income from independent personal services only where such income is attributable to a fixed base or permanent establishment in the source country.

The proposed treaty generally permits source country taxation of entertainers and athletes if the gross receipts derived by the individual in the source country exceed \$3,000. By contrast, the U.S. model generally would permit source country taxation of entertainers and athletes only if the gross receipts (including reimbursed expenses) exceed \$20,000.

Issue presented

One purpose of the proposed treaty is to reduce tax barriers to direct investment by U.S. firms in Turkey. The practical effect of these developing country concessions could be greater Turkish taxation of future activities of U.S. firms in Turkey than would be the case under rules that were comparable to those of either the U.S. model or the OECD model.

The issue is whether these developing country concessions represent appropriate U.S. treaty policy and, if so, whether Turkey is an appropriate recipient of these concessions. There is a risk that the inclusion of these concessions in the proposed treaty could result in additional pressure on the United States to include such concessions in future treaties negotiated with developing countries. However, a number of existing U.S. income tax treaties with developing countries already include similar concessions. Such concessions arguably are necessary in order to enter into treaties with developing countries. Tax treaties with developing countries can be in the interest of the United States because they provide reductions in the taxation by such countries of U.S. investors and a clearer framework for the taxation of U.S. investors. Such treaties also provide dispute resolution and nondiscrimination rules that benefit U.S. investors and exchange of information procedures that benefit the tax authorities.

C. Income from the Rental of Ships and Aircraft

The proposed treaty includes a provision found in the U.S. model and many U.S. income tax treaties under which profits from an en-

enterprise's operation of ships or aircraft in international traffic are taxable only in the enterprise's country of residence. In the case of profits derived from the rental of ships and aircraft, the rule limiting the right to tax to the country of residence applies to such rental profits only if the rental profits are incidental to other profits from the operation of ships and aircraft in international traffic. Rental profits that are not incidental to other income from the international operation of ships and aircraft generally would be taxable by the source country as royalties at the 5-percent rate (or as business profits if such profits are attributable to a permanent establishment). The U.S. model and many other treaties provide that profits from the rental of ships and aircraft operated in international traffic are taxable only in the country of residence, without requiring that the rental profits be incidental to income of the recipient from the operation of ships and aircraft. Under the proposed treaty, unlike under the U.S. model, an enterprise that engages only in the *rental* of ships and aircraft, but does not engage in the *operation* of ships and aircraft, would not be eligible for the rule limiting the right to tax income from operations in international traffic to the enterprise's country of residence. It should be noted that under the proposed treaty profits from the use, maintenance, or rental of *containers* used in international traffic are taxable only in the country of residence. The Committee may wish to consider whether the proposed treaty's rules treating profits from certain rental of ships and aircraft less favorably than profits from the operation of ships and aircraft are appropriate.

D. Certain Stock Gains

The proposed treaty contains a narrow rule under which a treaty country may tax in accordance with its internal law certain gains derived by a resident of the other country from the alienation of shares or bonds issued by a company that is resident in the first country. This rule applies only if (1) the shares or bonds are not quoted on a stock exchange of the country in which the company is resident, (2) the shares or bonds are alienated to a resident of the country in which the company is resident, and (3) the shares or bonds have been held by the resident of the other country for one year or less.

Although this provision would permit either country to impose its tax on stock gains derived by a resident of the other country in such circumstances, only Turkey imposes such a tax under its internal law. The United States generally does not tax nonresident individuals and foreign corporations on capital gains, other than gains with respect to a U.S. real property interest, unless such gains are effectively connected with a U.S. trade or business. The U.S. and OECD models are consistent with this approach. Accordingly, such models generally provide that gains are permitted to be taxed only in the country of residence (with specified exceptions for gains with respect to real property interests or with respect to a permanent establishment or fixed base). The targeted exception contained in the proposed treaty is not found in the U.S. or OECD models.

The provision creates the potential for double taxation of the gains derived by a U.S. resident or citizen from the alienation of

shares or bonds that are covered by the provision. U.S. internal law generally would treat gains realized by a U.S. person from the disposition of shares or bonds issued by a foreign corporation as U.S.-source income. The U.S. foreign tax credit rules permit foreign taxes to offset only U.S. taxes on foreign-source income. Under these rules, the Turkish taxes paid on such gains could not be used to offset the U.S. taxes paid on the same gains. The potential double taxation would have to be referred to the competent authorities of the two countries for possible relief.

The Committee may wish to consider whether the narrow provision of the proposed treaty that permits a treaty country to tax in certain cases gains derived by a resident of the other country from shares or bonds is appropriate.

E. Royalty Source Rules

Under the proposed treaty, royalties are sourced by reference to where the payor resides (or where the payor has a permanent establishment or fixed base, if the royalty was incurred and borne by the permanent establishment or fixed base). If this rule does not treat the royalty as sourced in one of the treaty countries, the royalty is sourced based on the place of use of the property. This source provision has been included in some other U.S. treaties (e.g., the 1995 U.S.-Canada protocol). However, this source provision is different than the U.S. internal law rule which sources royalties based on the place of use of the property.

Under the proposed treaty, if a Turkish resident that does not have a permanent establishment or fixed base in the United States pays a royalty to a U.S. resident for the right to use property exclusively in the United States, the proposed treaty would treat such royalty as Turkish source (and therefore potentially taxable in Turkey). However, U.S. internal law would treat such a royalty as U.S.-source income. The staff understands, however, that this situation would arise in relatively few cases (as opposed to the more common situation in which a Turkish resident using property in the United States would also have a permanent establishment or fixed base in the United States).

The Committee may wish to consider whether the treaty provision that sources royalties in a manner that is inconsistent with the U.S. internal law rules is appropriate.

F. Treaty Shopping

The proposed treaty, like a number of U.S. income tax treaties, generally limits treaty benefits for treaty country residents so that only those residents with a sufficient nexus to a treaty country will receive treaty benefits. Although the proposed treaty generally is intended to benefit residents of Turkey and the United States only, residents of third countries sometimes attempt to use a treaty to obtain treaty benefits. This is known as treaty shopping. Investors from countries that do not have tax treaties with the United States, or from countries that have not agreed in their tax treaties with the United States to limit source country taxation to the same extent that it is limited in another treaty may, for example, attempt to reduce the tax on interest on a loan to a U.S. person by

lending money to the U.S. person indirectly through a country whose treaty with the United States provides for a lower rate of withholding tax. The third-country investor may attempt to do this by establishing in that treaty country a subsidiary, trust, or other entity which then makes the loan to the U.S. person and claims the treaty reduction for the interest it receives.

The anti-treaty shopping provision of the proposed treaty is similar to anti-treaty shopping provisions in the Code (as interpreted by Treasury regulations) and in several recent treaties. Some aspects of the provision, however, differ from the anti-treaty shopping provision in the U.S. model. The issue is whether the anti-treaty shopping provision of the proposed treaty will be effective in forestalling potential treaty shopping abuses.

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

The Committee has in the past expressed its belief that the United States should maintain its policy of limiting treaty shopping opportunities whenever possible. The Committee has further expressed its belief that in exercising any latitude the Treasury Department has to adjust the operation of the proposed treaty, it should satisfy itself that its rules as applied will adequately deter treaty shopping abuses. The proposed treaty's ownership test may be effective in preventing third-country investors from obtaining treaty benefits by establishing investing entities in Turkey because third-country investors may be unwilling to share ownership of such investing entities on a 50-50 basis with U.S. or Turkish residents or other qualified owners in order to meet the ownership test of the anti-treaty shopping provision. The base erosion test contained in the proposed treaty will provide protection from certain potential abuses of a Turkish conduit. Finally, Turkey imposes significant taxes of its own; these taxes may deter third-country investors from seeking to use Turkish entities to make U.S. investments. On the other hand, implementation of the tests for treaty shopping set forth in the treaty may raise factual, administrative, or other issues that cannot currently be foreseen. Thus, the Committee may

wish to satisfy itself that the provision as proposed is an adequate tool for preventing possible treaty-shopping abuses in the future.

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