[JOINT COMMITTEE PRINT]

EXPLANATION OF PROPOSED PROTOCOL TO THE INCOME TAX TREATY BETWEEN THE UNITED STATES AND ISRAEL

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

ON OCTOBER 27, 1993

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

OCTOBER 26, 1993

U.S. GOVERNMENT PRINTING OFFICE

73-305 WASHINGTON : 1993 JCS-14-93

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-041716-3

JOINT COMMITTEE ON TAXATION

103D CONGRESS, 1ST SESSION

HOUSE

DAN ROSTENKOWSKI, Illinois
Chairman
SAM GIBBONS, Florida
J.J. PICKLE, Texas
BILL ARCHER, Texas
PHILIP M. CRANE, Illinois

SENATE

DANIEL PATRICK MOYNIHAN, New York
Vice Chairman
MAX BAUCUS, Montana
DAVID L. BOREN, Oklahoma
BOB PACKWOOD, Oregon
ROBERT DOLE, Kansas

HARRY L. BUTMAN, *Chief of Staff*
PETER V.Z. COBB, *Deputy Chief of Staff*
MARY M. SCHMITT, *Associate Chief of Staff (Law)*
BERNARD A. SCHMITT, *Associate Chief of Staff (Revenue Analysis)*

CONTENTS

	Page
INTRODUCTION	1
I. SUMMARY	2
II. ISSUES	7
III. EXPLANATION OF PROPOSED PROTOCOL	12
Article I. Taxes Covered	12
Article II. Fiscal Residence	13
Article III. Source of Income	15
Article IV. Permanent Establishment	15
Article V. General Rules of Taxation	15
Article VI. Income from Real Property	17
Article VII. Dividends	18
Article VIII. Interest	19
Article IX. Branch Tax	20
Article X. Capital Gains	22
Article XI. Governmental Functions	23
Article XII. Limitation on Benefits	24
Article XIII. Relief from Double Taxation	28
Article XIV. Nondiscrimination	30
Article XV. Exchange of Information	32
Article XVI. Amendment to Treaty Provision on Entry Into Force	32
Article XVII. Entry Into Force of the Protocol	33
Exchange of Notes	33
APPENDIX: DESCRIPTION OF THE TAX TREATY WITH ISRAEL (NOT YET RATIFIED), AS MODIFIED BY THE FIRST PROTOCOL (NOT YET RATIFIED)	35
Article 1. Taxes Covered	35
Article 2. General Definitions	36
Article 3. Fiscal Residence	36
Article 4. Source of Income	37
Article 5. Permanent Establishment	39
Article 6. General Rules of Taxation	40
Article 7. Income from Real Property	41
Article 8. Business Profits	41
Article 9. Shipping and Air Transport	43
Article 10. Grants	43
Article 11. Related Persons	45
Article 12. Dividends	45

	Page
Article 13. Interest	46
Article 14. Royalties	47
Article 15. Capital Gains	47
Article 15A. Charitable Contributions	48
Article 16. Independent Personal Services	48
Article 17. Dependent Personal Services	49
Article 18. Public Entertainers	49
Article 19. Amounts Received for Furnishing Personal Services of Others	50
Article 20. Private Pensions and Annuities	50
Article 21. Social Security Payments	50
Article 22. Governmental Functions	50
Article 23. Teachers	51
Article 24. Students and Trainees	51
Article 25. Investment or Holding Companies	52
Article 26. Relief from Double Taxation	52
Article 27. Nondiscrimination	54
Article 28. Mutual Agreement Procedure	55
Article 29. Exchange of Information	55
Article 30. Diplomatic and Consular Officials	56
Article 31. Entry into Force	56
Article 32. Termination	56
Exchange of Notes	57

INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, describes the proposed second protocol to the income tax treaty between the United States and Israel. The proposed protocol was signed in Jerusalem on January 26, 1993, and was amplified by an exchange of notes signed the same day. The proposed protocol would amend the U.S.-Israel income tax treaty, which was signed on November 20, 1975, as amended by the first protocol, which was signed on May 30, 1980. The U.S.-Israel income tax treaty (as amended by the first protocol) received the Senate's advice and consent to ratification on November 18, 1981, subject to an understanding providing for Congressional access to information exchanged under the treaty. The understanding proved to be unacceptable to Israel and the treaty did not enter into force. A public hearing on the proposed protocol is scheduled on October 27, 1993, by the Senate Committee on Foreign Relations.

The proposed protocol further amends the treaty, as amended by the first protocol, in large measure to accommodate certain post-1980 provisions of U.S. tax law and treaty policy (including the Tax Reform Act of 1986). The proposed protocol also reflects changes in Israeli law and makes certain technical corrections to the treaty that are necessary because of the passage of time.

The proposed protocol replaces the language on the exchange of information appearing in the treaty and the first protocol with language used in 12 tax treaties to which the Senate has given advice and consent since 1981. In incorporating that formula in the proposed protocol, both governments understood and agreed that the treaty, as amended, will permit access by the U.S. General Accounting Office and Congressional tax-writing committees to confidential information exchanged under the treaty in connection with their performance of oversight functions.

Part I of the pamphlet is a summary of the principal provisions of the proposed protocol. Part II presents a discussion of the issues raised by the proposed protocol. Part III contains a detailed, article-by-article explanation of the proposed protocol.[2] The Appendix to the pamphlet contains a detailed, article-by-article explanation of the treaty (as amended by the first protocol), reprinted from the 1981 report of the Senate Foreign Relations Committee accompanying the proposed tax treaty and first protocol between the United States and Israel.[3]

---

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty between the United States and Israel* (JCS–14–93), October 26, 1993.

[2] For a copy of the proposed protocol, see Senate Treaty Doc. 103-16, October 19, 1993.

[3] *Tax Convention (and Proposed Protocol) with the State of Israel,* Sen. Exec. Rept. No. 97-29, 97th Cong., 1st Sess. (1981).

I. SUMMARY

The proposed protocol contains the following principal modifications to the income tax treaty between the United States and Israel.[4]

(1) Taxes covered.—The proposed protocol amends the coverage of the treaty in several respects. In the case of the United States, specific reference is made to the Internal Revenue Code of 1986, and social security taxes are expressly excluded from the income taxes generally covered. In the case of Israel, the description of generally covered taxes is amended to reflect changes in the statutory tax laws of Israel that have been enacted since the signing of the first protocol to the treaty in 1980. The coverage of the nondiscrimination article is extended to include all state and political subdivision taxes as well as all national-level taxes.

(2) Fiscal residence.—The proposed protocol modifies the residence rules of the treaty in two respects.

- First, it clarifies the treaty's rule that U.S. citizenship alone does not establish U.S. residence under the treaty. Under the proposed protocol, a U.S. citizen or green-card holder who is not treated as a resident of Israel under the treaty's rules (e.g., a resident of a third country) would be treated as a resident of the United States for purposes of the treaty only if that individual has a substantial presence, permanent home, or habitual abode in the United States. Thus, a U.S. citizen or green-card holder who has no such connection with the United States is not entitled to treaty benefits solely on the basis of U.S. citizenship or a U.S. green-card. If a U.S. citizen or green-card holder is a resident of Israel under the treaty rules, the proposed protocol provides that any such individual be treated as a resident of both the United States and Israel, and the residence of that individual for purposes of the treaty would be determined under the treaty's tie-breaker rules.
- Second, the proposed protocol extends and modifies the treaty rule that generally denies treaty benefits in the case of a dual-resident company. Under the proposed protocol, this rule applies to any dual resident other than an individual. Further, it is not to apply if the competent authorities settle the question of residence otherwise by mutual agreement and determine the mode of application of the treaty to such person. Finally, the proposed protocol clarifies that dual residence does not deprive the entity itself of benefits under the double taxation article, and allows other persons that receive dividends, interest, and

[4] All references to the treaty between the United States and Israel are to the Convention Between the Government of the United States of America and the Government of the State of Israel with respect to Taxes on Income, signed on November 20, 1975, as amended by the Protocol signed on May 30, 1980. All references to a proposed protocol are to the proposed second protocol, which was signed on January 26, 1993.

royalties paid by the dual-resident entity to benefit from the treaty's limitations on source-based taxation of such items.

(3) Source of income.—The proposed protocol modifies the source rules of the treaty in conformity with the proposed protocol's amendments to the substantive rules of taxation of the treaty.

(4) Permanent establishment.—The proposed protocol conforms the permanent establishment rules of the treaty as they pertain to the treatment of a dependent agent to recent model treaties. As modified, a dependent agent does not constitute a permanent establishment in a case where the activities of the agent are limited to those activities, specified in the treaty, for which a fixed placed of business may be used and yet not constitute a permanent establishment.

(5) General rules of taxation.—The proposed protocol clarifies the application of the treaty's saving clause, under which the United States and Israel may each tax their own residents and citizens without regard to the limitations set forth in the treaty. Under the proposed protocol, in conformity with current U.S. treaty policy, treatment as a citizen applies to a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of tax, for a period of ten years after the loss of citizenship. The proposed protocol also clarifies that the saving clause does not override the treatment provided in Article 20 of the treaty, under which alimony and annuities are taxable only by the country of the recipient's residence, and child support payments are exempt from tax by the country of the recipient's residence.

The proposed protocol expands the concept of a permanent establishment to encompass deferred payments, as in Code section 864(c)(6). Under the proposed protocol, types of income or gain that would be taxable in the source country if attributable to a permanent establishment or fixed base are treated as attributable to such a permanent establishment or fixed base, and therefore taxable by the source country, even if the permanent establishment or fixed base to which the payments are attributable has ceased to exist by the time the payment is remitted from the source country.

The proposed protocol includes an understanding regarding possible future treaty amendments in response to significant future changes in the domestic law or policy of either country. If domestic legislation by one country significantly alters the balance of benefits provided under the treaty, the appropriate authorities of the United States and Israel are to endeavor to amend the treaty to restore an appropriate balance of benefits. In addition, if other changes in one country's treaty policy or domestic law make it appropriate to amend the treaty, these authorities are to consult to consider such amendments.

(6) Income from real property.—The proposed protocol clarifies that the treaty's rules allowing the taxation of gain on real property and real property interests are fully consistent with the provisions of the Foreign Investment in Real Property Act of 1980 (FIRPTA), as amended. The United States is specifically permitted to tax gains derived by a resident of Israel from the disposition of any "U.S. real property interest," or the disposition of an interest in a partnership, trust or estate to the extent attributable to a U.S. real property interest. Israel is permitted to tax gains derived by

a resident of the United States from the disposition of a comparable interest in real property in Israel.

(7) Dividends.—The proposed protocol provides that the treaty's limitations on the rate of source country taxation of dividends does not apply to dividends paid by certain types of companies. The treaty's direct dividend withholding rate of 12.5 percent is not applicable to dividends paid by a U.S. Regulated Investment Company (RIC) or a Real Estate Investment Trust (REIT); neither does the portfolio dividend withholding rate of 25 percent apply to dividends paid by a REIT, unless the beneficial owner of the dividend is an individual holding a less than 10-percent interest in the REIT. The limitations on source country taxation of dividends do not apply to taxes imposed by Israel on dividends paid to U.S. investors by certain Israeli companies that are taxed as pass-through entities under Israeli law. Such dividends are treated like business profits from permanent establishments in Israel, and therefore taxable on a net basis in Israel.

(8) Interest.—The proposed protocol makes available an alternative method of taxing interest income in the source country. Instead of being subjected to gross-basis tax in the source country at the treaty's reduced rates (which are either 0, 10, or 17.5 percent, depending on the circumstances), the treaty resident is permitted to elect taxation on a net basis as if the interest income were business profits attributable to a permanent establishment in the other treaty country.

The proposed protocol also provides, in conformity with U.S. tax policy, that the treaty's reductions and exemptions for withholding tax on interest do not apply to any excess inclusion with respect to a residual interest in a real estate mortgage investment conduit (REMIC).

(9) Branch tax.—The proposed protocol adds a new article to the treaty that expressly permits the United States to impose the branch profits tax (at a 12.5-percent rate) and the branch-level excess interest tax (at a 5-percent rate) on an Israeli company. In addition, the new treaty article permits Israel to impose similar branch-level taxes on U.S. corporations.

(10) Capital gains.—The proposed protocol modifies certain exceptions to the treaty rule that generally exempts a resident of one treaty country from tax by the other treaty country on gains from the sale, exchange, or other disposition of capital assets. The treaty provision that permits Israel to tax certain stock gains derived by a resident of the United States from the sale, exchange, or other disposition of stock in an Israeli corporation is modified by the proposed protocol. As amended by the proposed protocol, that treaty provision permits the taxation of direct-investment stock gains by the source country on a reciprocal basis, (i.e., by the United States as well as by Israel), and substantially reduces the ownership threshold for the allowance of taxation to a minimum of 10 percent. Under the Internal Revenue Code, however, no tax generally is imposed by the United States on direct-investment stock gains in U.S. companies realized by foreign residents. In addition, a limitation on the amount of taxable gain is provided in the case of certain transfers of stock between certain related persons.

(11) Governmental functions.—The treaty, like the proposed 1981 U.S. model income tax treaty (the "U.S. model") and many U.S. treaties in force, reserves to each treaty country the right to tax certain of its own government employees on certain income they are paid from public funds. The proposed protocol clarifies the treaty by adding definitions of public funds and public employment. Public funds are defined as the funds of (a) the treaty country itself, or a political subdivision or local authority thereof, (b) a corporation wholly owned by such a governmental body that performs functions of a governmental nature, or (c) any other body that is treated for tax purposes under the laws of the treaty country in the same manner as such a governmental body, and that performs governmental functions. Employment by a treaty country is defined to include employment by any entity the funds of which are treated as public funds.

(12) Limitation on benefits.—The proposed protocol replaces the treaty's article on "Investment or Holding Companies" with a modern "Limitation on Benefits" article, which is intended to limit indirect use of the treaty by persons who are not entitled to its benefits by reason of residence in the United States or Israel. The new article is similar to the corresponding provisions included in other recently ratified U.S. tax treaties, such as the treaty between the United States and Germany.

(13) Relief from double taxation.—The proposed protocol deletes from the treaty special rules pertaining to the application of U.S. foreign tax credits with respect to compulsory loans to Israel. The proposed protocol also provides specific rules for the application of foreign tax credits in the case of certain types of income derived from sources in the United States by U.S. citizens who are resident in Israel. The proposed protocol also coordinates the treaty's source rules with special source rules provided under each country's domestic laws for purposes of foreign tax credits.

(14) Nondiscrimination.—The proposed protocol replaces the treaty's prohibition of discrimination against citizens of the other treaty country with the broader provision that is contained in the U.S. model treaty. The proposed protocol states explicitly that, for purposes of U.S. tax, a U.S. citizen who is not a resident of the United States is not in the same circumstances as an Israeli citizen who is not a resident of the United States. The proposed protocol also specifies that the treaty's nondiscrimination rules will not prevent either treaty country from imposing branch-level taxation as allowed under the treaty.

(15) Exchange of information.—The proposed protocol brings the treaty's rules for the permissible use of exchanged information into conformity with the corresponding provisions of the U.S. model treaty and other recent U.S. tax treaties. Under the proposed protocol, information that is exchanged under the authority of the treaty is permitted to be disclosed to persons or authorities concerned with the administration of the taxes that are the subject of the treaty.

(16) Entry into force.—The proposed protocol amends the effective date of the treaty. Under the proposed protocol, the treaty becomes effective with respect to taxes other than withholding taxes for taxable years beginning on or after January 1 of the year (a)

in which the treaty enters into force, if the treaty enters into force prior to July 1 of that year, or (b) following the year in which the treaty enters into force, if the treaty enters into force after June 30 of any calendar year. Therefore, if the treaty enters into force prior to July 1, 1994, its provisions will be effective with respect to taxes other than withholding taxes in taxable years beginning on or after January 1, 1994. Absent the proposed protocol, on these facts the treaty would apply to such taxes only for taxable years beginning on or after January 1, 1995. The proposed protocol enters into force 30 days after the exchange of instruments of ratification.

II. ISSUES

The proposed protocol raises the following specific issues.

(1) Treaty shopping

The proposed protocol, like all recent 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 would receive treaty benefits. Although the proposed treaty generally is intended to benefit residents of Israel 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 attempt to secure a lower rate of tax by, for example, lending money to a U.S. person indirectly through a country whose treaty with the United States provides for a lower rate. The third-country investor may attempt to do this by establishing in that treaty country a subsidiary, trust, or other investing 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 added to the Israel treaty by the proposed protocol is similar to an anti-treaty-shopping provision in the Internal Revenue Code (as interpreted by Treasury regulations) and in several newer U.S. tax treaties. Some aspects of the provision, however, differ either from an anti-treaty-shopping provision proposed at the time that the U.S. model treaty was proposed or from the anti-treaty-shopping provisions sought by the United States in some treaty negotiations since the model was published in 1981. The issue is whether the anti-treaty-shopping provision of the treaty would effectively forestall potential treaty-shopping abuses.

One provision of the anti-treaty-shopping article of the proposed protocol is more lenient than the comparable rule in one version proposed with the U.S. model treaty. That U.S. model proposal allows benefits to be denied if 75 percent or less of a resident company's stock is held by individual residents of the country of residence, while the proposed treaty (like several newer treaties and an anti-treaty-shopping provision in the Internal Revenue Code) lowers the qualifying percentage to 50, and broadens the class of qualifying shareholders to include residents of either treaty country, as well as the governments of the two countries (including local authorities and political subdivisions thereof), and certain public companies and tax-exempt entities that are qualifying residents of either the United States or Israel. Thus, this safe harbor is considerably easier to enter under the proposed protocol. On the other

hand, counting for this purpose shareholders who are individuals and other qualifying residents of either treaty country does not appear to invite the type of abuse at which the provision is aimed, inasmuch as the targeted abuse is ownership by third-country residents attempting to obtain treaty benefits.

Another provision of the anti-treaty-shopping article differs from the comparable rule some earlier U.S. treaties and proposed model provisions, but the effect of the change is less clear. The general test applied by those treaties to allow benefits, short of meeting the bright-line ownership and base erosion test, 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 protocol presents a more precise test that allows denial of benefits only with respect to income not derived in connection with the active conduct of a trade or business. (However, this active trade or business test generally does not apply with respect to a business of making or managing investments, so benefits could be denied with respect to such a business regardless of how actively it is conducted.) In addition, the proposed protocol gives the competent authority of the country in which the income arises the ability to override this standard.

The proposed protocol also includes a specific rule in its anti-treaty-shopping article that is new to U.S. treaties. Under a disproportionate ownership test, treaty benefits are not available in a case where the treaty resident company has outstanding a class of stock that entitles its holders to a disproportionately high share of the income derived in the other treaty country from assets located there or activities conducted there, if third-country residents own a majority of the shares of that class. This test prevents third-country residents from claiming the benefits of the treaty through the use of so-called "alphabet" stock.

The practical difference between the proposed protocol tests and the earlier tests would depend upon how they are interpreted and applied. The principal purpose test may be applied leniently (so that any colorable business purpose suffices to preserve treaty benefits), or it may be applied strictly (so that any significant intent to obtain treaty benefits suffices to deny them). Similarly, the standards in the proposed protocol could be interpreted to require, for example, a more active or a less active trade or business (though the range of interpretation is far narrower). Thus, a narrow reading of the principal purpose test could theoretically be stricter than a broad reading of the proposed treaty tests (i.e., the principal purpose test might operate to deny benefits in potentially abusive situations more often).

It is believed that the United States should maintain its policy of limiting treaty-shopping opportunities whenever possible, and in exercising any latitude Treasury has to adjust the operation of the proposed treaty it should satisfy itself that its rules, as applied, adequately deter treaty shopping abuses. The proposed anti-treaty-shopping provision may be effective in preventing third-country investors from obtaining treaty benefits by establishing investing entities in Israel inasmuch as third-country investors may be unwilling to share ownership of such investing entities on a 50-50 basis with U.S. or Israeli residents or other qualified owners to meet the

ownership test of the anti-treaty-shopping provision. The base erosion test would provide protection from certain potential abuses of an Israeli conduit. Finally, Israel imposes significant taxes of its own; these taxes may deter third-country investors from seeking to use Israeli 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.

(2) Changes in domestic law or policy

The proposed protocol addresses the subject of possible future treaty amendments in response to significant future changes in the domestic law or policy of either country. If domestic legislation by one country significantly alters the balance of benefits provided under the treaty, the appropriate authorities "shall promptly endeavor to amend" the treaty to restore an appropriate balance of benefits. In addition, if changes in one country's treaty policy or domestic law "make it appropriate" to amend the treaty, the appropriate authorities "shall promptly consult to consider such amendments."

The Exchange of Notes provides some examples of this understanding, which would be set forth in Article 6 (General Rules of Taxation) of the treaty. First, the Exchange of Notes recites an agreement that if the United States ever grants a tax-sparing credit to another county, the treaty "shall be promptly amended to incorporate such a provision."

The Exchange of Notes also provides two examples of possible changes in domestic law or policy that "may make it appropriate" to amend the treaty. The two examples are more liberal foreign tax credit benefits extended to taxes imposed by a third country, and the possible integration of corporate and individual taxation under domestic law, where integration benefits are provided under a tax treaty with a third country. In both of these cases, the Exchange of Notes suggests that treaty amendments should be considered.[5]

The Committee may wish to clarify the degree, if any, to which consent to the proposed protocol represents any predisposition to act favorably with respect to any future protocols or treaties negotiated as contemplated by the authors of the above language.

---

[5] The Exchange of Notes also recites an understanding with respect to a provision added by the proposed protocol (new paragraph 8 of treaty Article 13) to eliminate a problem of U.S. domestic tax avoidance by permitting the source country to impose its full statutory rate of withholding tax on any interest income in the form of an excess inclusion with respect to a residual interest in a real estate mortgage investment conduit (REMIC). If the United States were to amend the Internal Revenue Code to eliminate this problem in a manner other than by imposing tax on the recipient of the excess inclusion with respect to a REMIC, such excess inclusions would from that point be treated as ordinary interest income in the hands of nonresident recipients, and thus (notwithstanding the provision added by the proposed protocol) would not be subject to tax by the United States. The Exchange of Notes further states that, should the United States fail to include a provision similar to this new paragraph of Article 13 (Interest) in U.S. tax treaties signed subsequent to the entry into force of this treaty, without having amended the Internal Revenue Code to eliminate the domestic tax avoidance problem, that would be considered a change in U.S. treaty policy that would make it appropriate to amend the tax treaty.

(3) Interest

The treaty permits significantly higher rates of source-country taxation of interest income than is permitted by most U.S. tax treaties. Under the treaty, interest (other than certain non-governmental interest) is subject to source-country tax on a gross basis at rates not to exceed 10 percent in the case of interest on a loan from a bank or other financial institution, or 17.5 percent in the case of any other interest. The proposed protocol, however, offers an election to a treaty resident to be taxed on a net basis as if the interest income were industrial and commercial profits attributable to a permanent establishment in the other treaty country, and taxable under Article 8 (Business Profits) of the treaty. The proposed protocol authorizes the competent authorities of each country to adopt reasonable rules for the determination and reporting of such net basis taxable income, as well as procedures to insure that the treaty resident deriving interest income from the source country makes available to the tax authorities of the source country such books and records as are necessary to determine the proper amount of the tax.

One purpose of the treaty is to reduce tax barriers to direct investment by U.S. firms in Israel. The practical effect of higher source-country taxation of interest income could be greater Israeli taxation of future activities of U.S. firms in Israel than would be the case under the rules of either the U.S. or OECD model treaties. However, the Committee approved the treaty's rates of withholding tax on interest when it gave its advice and consent to ratification of the treaty in 1981. The issue for the Committee to consider at this time is to what extent the net-basis election provided in the proposed protocol may be a useful and appropriate amelioration of the treaty's high rates of gross-basis taxation of interest.

(4) Congressional access to information received under the treaty

Article 29 (Exchange of Information) of the treaty, as in all U.S. income tax treaties, requires the exchange of information that is necessary to carry out the provisions of the treaty or of the domestic tax laws of the two countries. The treaty article, however, contains a provision not found in more recent U.S. treaties that limits access to information received by the United States and Israel under the treaty to persons involved in the assessment or collection of taxes. A similar provision in treaties in force has been interpreted by the IRS as precluding Congressional access, specifically General Accounting Office (GAO) access, to mutual agreement case files. The appropriate Congressional oversight committees and the GAO thus have been hampered in their attempts to audit IRS administration of mutual agreement cases which may involve significant revenue.

At the time the treaty came before the Committee in 1981, this issue was of significant concern to the Senate Finance Committee, the House Ways and Means Committee, and the Joint Committee on Taxation, which are charged with the responsibility for oversight of the IRS. The Committee expressed its belief that such access is permitted and that those Committees and the GAO should, pursuant to the procedures established in the Internal Revenue

Code, have access to information exchanged under the treaties, including the mutual agreement case files, where they believe it is necessary to carry out their oversight functions. Accordingly, based on the Committee's recommendation, the Senate gave its advice and consent to the ratification of the treaty (along with the first protocol)—

> subject to the understanding that appropriate Congressional committees, and the General Accounting Office, shall be afforded access to the information exchanged under this treaty and protocol where such access is necessary to carry out their oversight responsibilities, subject only to the limitations and procedures of the Internal Revenue Code.

The effect of this understanding was to clarify that the treaty would authorize the Senate Finance Committee, the House Ways and Means Committee, and the Joint Committee on Taxation, as well as the GAO, to have access to all information received under the treaty.

The 1981 understanding was not accepted by the Government of Israel in 1981, however, and instruments of ratification have not been exchanged between the United States and Israel with respect to the treaty and first protocol.

The proposed protocol amends Article 29 (Exchange of Information) of the treaty so as to bring the treaty's rules for the permissible use of exchanged information into conformity with the corresponding provisions of the U.S. model treaty and other recent U.S. tax treaties, and thereby resolve the issue on account of which the 1981 understanding was necessary. Specifically, under the proposed protocol, information that is exchanged under the authority of the treaty is permitted to be disclosed to persons or authorities concerned with the administration of the taxes that are the subject of the treaty. Such persons or authorities are intended to include the tax-writing committees of Congress and the General Accounting Office, for their use in the performance of their roles in overseeing the administration of the tax laws. Therefore, it appears that ratification of this proposed protocol without reservation or understanding is consistent with the understanding subject to which the Senate gave its advice and consent to ratification of the treaty and first protocol in 1981. The Committee may wish to satisfy itself that this appearance accurately reflects the effect of the proposed protocol.

III. EXPLANATION OF PROPOSED PROTOCOL

A detailed, article-by-article explanation of the proposed protocol to the income tax treaty between the United States and Israel is presented below. The explanation incorporates a discussion of the explanatory notes, signed together with the proposed protocol, into the discussion of the protocol provision to which the notes relate.

Article I. Taxes Covered

Article I of the proposed protocol amends Article 1 (Taxes Covered) of the treaty in several respects. First, in referring to the U.S. taxes covered by the treaty, the proposed protocol makes specific reference to the Internal Revenue Code of 1986. This amendment clarifies that the changes to the Internal Revenue Code brought about by the Tax Reform Act of 1986 are taxes covered by the treaty. This clarification precludes any argument that new taxes added to the Code in 1986, such as the branch profits tax, are not substantially similar to the taxation under the Code prior to the Tax Reform Act of 1986, and therefore might not be covered by the treaty.

Second, the proposed protocol specifies that U.S. social security taxes are not covered by the treaty. Accordingly, if a resident of Israel performs personal services in the United States that are exempt from U.S. taxation under the terms of the treaty, compensation for such personal services will be subject to the ordinary social security tax laws under the Code. It generally is U.S. treaty policy to exclude social security taxes from the coverage of income tax treaties, leaving any bilateral modifications of statutory social security laws to social security totalization agreements. There is no social security totalization agreement in effect between the United States and Israel.

Third, the proposed protocol specifies that the Israeli taxes covered by the treaty are those imposed by the Israeli Income Tax Ordinance, the Land Appreciation Tax Law, the Income Tax Law (Adjustments for Inflation), and other taxes on income administered by the Government of Israel (including, but not limited to, the profit tax on banking institutions and insurance companies and the income tax component of a compulsory loan [6]). This amendment conforms to modifications of Israeli tax laws that have been enacted since the treaty was signed. The first paragraph of the Exchange of Notes clarifies that "other taxes on income administered by the Government of Israel" refers only to taxes imposed solely under Israeli law.

Fourth, the proposed protocol replaces the provision of Article 1 of the treaty which specifies the levels of taxation to which the

[6] The staff understands that, although the compulsory loan provisions of Israeli law have been repealed, some compulsory loans may remain outstanding.

treaty's nondiscrimination clause (Article 27) applies. Under revised paragraph 3 of treaty Article 1, as clarified by paragraph 2 of the Exchange of Notes, the nondiscrimination rules of the treaty apply to taxes of any kind imposed at the national level, at a State level, or by a political subdivision or local authority. As so amended, this provision is consistent with U.S. treaty policy.

Article II. Fiscal Residence

Article II of the proposed protocol would amend Article 3 (Fiscal Residence) of the treaty significantly, primarily with respect to the treatment of U.S. citizens and green-card holders[7] who do not reside in the United States, and persons who might be considered residents of both the United States and Israel under the treaty's general definition of residence. The assignment of a country of residence is important because the benefits of the treaty generally are available only to a resident of one of the countries as that term is defined in the treaty. Furthermore, double taxation is often avoided in the treaty by assigning one of the countries as the country of residence if, under the laws of the two countries, a person would be treated as a resident of both countries.

Consistent with most U.S. income tax treaties, the U.S.-Israel treaty provides that citizenship alone in a treaty country does not establish residence in that country. This result is contrary to U.S. treaty policy as expressed in the U.S. model, but the U.S. model result has been achieved in few treaties. As a result, U.S. citizens residing in third countries are not necessarily entitled to the benefits of the treaty as U.S. residents. The proposed protocol clarifies the operation of the treaty in this respect by providing that a U.S. citizen or green-card holder who is not treated as a resident of Israel under the treaty's rules would be treated as a resident of the United States for purposes of the treaty only if that individual has a substantial presence, permanent home, or habitual abode in the United States. Accordingly, a U.S. citizen (or a noncitizen who holds a U.S. green-card) who resides in neither the United States nor Israel and who does not maintain a substantial presence, permanent home or habitual abode in the United States, is not entitled to treaty benefits as a resident of the United States solely on the basis of U.S. citizenship or a U.S. green-card. If a U.S. citizen or green-card holder is a resident of Israel under the treaty rules, the proposed protocol provides that any such individual be treated as a resident of both the United States and Israel, and the residence of that individual for purposes of the treaty is to be determined under the treaty's tie-breaker rules.

Paragraph 3 of the Exchange of Notes clarifies that the term "resident in Israel for purposes of Israeli tax," as used in the treaty's definition of a resident of Israel, includes persons on whom taxes are imposed by Israel, under the Income Tax Ordinance, on income from sources outside Israel by virtue of their being Israeli citizens. The staff understands that this does not mean that Israeli citizenship alone confers Israeli residence status under the treaty as modified by the proposed protocol. The staff understands that taxes generally are not imposed by Israel under the Income Tax

[7] I.e., aliens admitted to the United States for permanent residence.

73-305 O - 93 - 2

Ordinance on income from sources outside Israel by virtue solely of Israeli citizenship. Rather, Israeli citizens who reside outside of Israel on more than a temporary basis generally are subject to Israeli income tax only on income from sources in Israel.

The proposed protocol also updates a reference to the provision of the Israeli Income Tax Ordinance that defines "*oleh*," a certain category of immigrant, in conformity with Israeli statutory amendments that were enacted since the signing of the treaty.

Article II of the proposed protocol also replaces the treaty provision (paragraph 3 of Article 3) that generally excludes a dual-resident corporation--i.e., one that is treated both as a resident of Israel and as a resident of the United States under the treaty's residence rules--from the scope of the treaty. The proposed protocol applies a corresponding rule to all persons other than individuals, rather than only to corporations as in the treaty. The proposed protocol provisions apply primarily to a corporation that is incorporated in the United States but managed and controlled in Israel.

In addition, the proposed protocol, unlike the treaty, provides that in the case of such a dual-resident entity, the determination of the residence of that person for purposes of the treaty will be referred to the competent authorities of the United States and Israel, who are to endeavor to settle the question by mutual agreement and determine the mode of application of the treaty to the entity. Pending such a competent authority determination, the dual-resident person is treated as a resident neither of the United States nor of Israel, except for purposes of certain specified treaty provisions. These specified purposes allow treaty benefits only under Article 26 (under which a dual-resident person may claim the benefits of the foreign tax credit) and Article 27 (under which neither the United States nor Israel is permitted to discriminate against a dual-resident person). The other specified treaty purposes are largely definitional, rather than providing benefits: the dual-resident person is treated as a resident of one or both of the treaty countries for purposes of the treaty's provision for entry into force (so that the treaty may be regarded as in force with respect to the dual-resident person), and for the provisions of Article 12 (Dividends), Article 13 (Interest), and Article 14 (Royalties) that deal with the duties of a payor of an amount of income for which the recipient is entitled to treaty benefits.

Under the proposed protocol, the dual-resident person is not treated as a resident of either the United States or Israel for purposes of Article 29 (Exchange of Information). Inasmuch as the application of Article 29 is not restricted to residents, however, information may be exchanged with respect to dual-residents under Article 29.

Paragraph 4 of the Exchange of Notes clarifies that the limited application of the treaty to dual-resident persons other than individuals includes the application of related treaty provisions that are necessary to apply the specified treaty provisions. For example, paragraph 4 of the Exchange of Notes specifies that, in the case of a dividend payment made by a dual-resident company, the source rules of Article 4 will apply "to the extent necessary to insure proper treatment" under the treaty.

Article III. Source of Income

Article III of the proposed protocol makes two amendments to the source rules of Article 4 of the treaty. In both cases, the proposed protocol modifies the source rules in conformity with amendments to the treaty's substantive rules of taxation made elsewhere by the proposed protocol.

First, the proposed protocol provides a reciprocal source rule under which gains derived by a resident of one treaty country from the disposition of stock of a corporation of the other treaty country is treated as arising from sources in that second country in cases where such gains are permitted to be taxed by the second country under Article 15 (Capital Gains) of the treaty, as modified by Article X of the proposed protocol.[8] Paragraph 5 of the Exchange of Notes clarifies that the U.S. foreign tax credit may be applied separately for taxes paid to Israel on such stock gains realized by residents of the United States, under section 865(h) of the Internal Revenue Code.

Second, Article III of the proposed protocol conforms the source rule applicable to certain social security payments and compensation for governmental services to the substantive rules for the taxation of such payments provided in Article 21 (Social Security Payments) and Article 22 (Governmental Functions) of the treaty, as amended by Article XI of the proposed protocol. As in the case of the amendment to the source rules applicable to stock gains, the proposed protocol provides that such social security payments and compensation for governmental services are to be treated as arising from sources in the treaty country that is permitted to tax such items of income under the treaty's substantive rules of taxation.

Article IV. Permanent Establishment

Article IV of the proposed protocol amends the permanent establishment rules of treaty Article 5 (Permanent Establishment) as they pertain to the treatment of a dependent agent. Under the proposed protocol, as under the most recent United States, United Nations, and OECD model treaties, a dependent agent does not constitute a permanent establishment in a case where the activities of the agent are limited to those activities (specified in paragraph 3 of treaty Article 5) for which a fixed place of business may be used and yet not constitute a permanent establishment.

Article V. General Rules of Taxation

Article V of the proposed protocol makes several amendments to Article 6 (General Rules of Taxation) of the treaty. First, the proposed protocol clarifies the application of the saving clause (paragraph 3 of Article 6), under which the United States and Israel may each tax their own residents and citizens, without regard to the limitations set forth in the treaty. Under the proposed protocol, treatment as a citizen applies to a former citizen whose loss of citi-

---

[8] As is discussed below in the explanation of the proposed protocol's Article X, the treaty (prior to amendment by the proposed protocol) would have permitted taxation by Israel of certain gains attributable to the disposition of stock in Israeli corporations, realized by residents of the United States, but would not have permitted taxation by the United States of similar gains realized by residents of Israel attributable to the disposition of stock in U.S. corporations. Although the treaty and proposed protocol permit the United States to impose taxation on certain U.S. stock gains realized by residents of Israel, the Internal Revenue Code imposes no such taxation.

zenship had as one of its principal purposes the avoidance of tax, for a period of 10 years after the loss of citizenship. Therefore, in conformity with current U.S. treaty policy with regard to former citizens, the proposed protocol permits the United States to apply Code section 877, under which full U.S. taxation is imposed for a period of ten years on certain U.S. source income of former U.S. citizens whose loss of U.S. citizenship had a tax avoidance purpose. The proposed protocol also provides for consultations between the competent authorities of the United States and Israel in the case of the application of this rule to a former citizen of one of the treaty countries who is a resident of the other treaty country.

The proposed protocol also specifies two additional types of income as not subject to the saving clause. The proposed protocol clarifies that the saving clause does not override the treatment provided in Article 20 (Private Pensions and Annuities) of the treaty, under which alimony and annuities are taxable only by the country of the recipient's residence, and child support payments are exempt from tax by the country of the recipient's residence.

The proposed protocol modifies the "remittance basis" rule of the treaty, which coordinates source-country tax reductions with remittance-based taxation in the residence country. Under the treaty, in a case where tax is relieved in the source country on a type of income that is taxed in the residence country only on a basis on the amount actually received in the latter country, then the source-country tax relief applies only to the extent of the amount actually remitted to the residence country during the taxable year in which the income is earned in the source country. The proposed protocol extends the remittance period by three months, to allow full source-country tax relief on income that is remitted either during the year it is earned or in the first three months of the following taxable year.

The proposed protocol adds two new paragraphs to Article 6 of the treaty. New paragraph 7 of treaty Article 6 expands the concept of a permanent establishment to encompass deferred payments. Under the proposed protocol, types of income or gain that would be taxable in one country if attributable to a permanent establishment or fixed base are treated as attributable to such a permanent establishment or fixed base, and therefore taxable by the host country, even if the permanent establishment or fixed base to which the income or gain is attributable has ceased to exist by the time payment is received. This treatment is consistent with Code section 864(c)(6), which was added by the Tax Reform Act of 1986.

The second new paragraph, paragraph 8 of Article 6 of the treaty, represents an understanding concerning circumstances under which the treaty may be amended in response to significant future changes in the domestic law or policy of either country. The new treaty paragraph refers to consultations between "the appropriate authority" of one country and its counterpart in the other country to determine whether amendment is appropriate in response to changes in the law or policy of either country. The Treasury Department's Technical Explanation of the proposed protocol (herein-

after "Technical Explanation")[9] explains that these appropriate authorities may be the governments of the United States and Israel, communicating through diplomatic channels, or the competent authorities under the treaty, communicating in their usual direct fashion. The new paragraph provides that if domestic legislation by one country significantly alters the balance of benefits provided under the treaty, the appropriate authorities "shall promptly endeavor to amend" the treaty to restore an appropriate balance of benefits. New paragraph 8 also states that if changes in one country's treaty policy or domestic law "make it appropriate" to amend the treaty, these authorities "shall promptly consult to consider such amendments."

Paragraphs 6 and 7 of the Exchange of Notes set forth some examples of the understanding reflected in new paragraph 8 of treaty Article 6. Paragraph 6 of the Exchange of Notes recites an agreement that if the United States ever grants a tax-sparing credit to another county, the treaty "shall be promptly amended to incorporate such a provision."

Paragraph 7 of the Exchange of Notes provides two examples of possible changes in domestic law or policy that "may make it appropriate" to amend the treaty. The two examples are (1) more liberal treaty benefits (e.g., foreign tax credit benefits) extended to a third country, and (2) changes in domestic law that result in the allowance of treaty benefits to a third country (e.g., the possible integration of corporate and individual taxation under domestic law, where integration benefits are provided under a tax treaty with a third country). In both of these cases, paragraph 7 of the Exchange of Notes suggests that treaty amendments should be considered.

Paragraph 7 of the Exchange of Notes goes on to recite an understanding that the two countries will consult about possible amendments to the treaty in the event that one country adopts new domestic rules that treat expenses incurred within that country more favorably than expenses incurred in the other treaty country, so long as the Free Trade Area Agreement between the United States and Israel remains in force.[10]

Article VI. Income from Real Property

Article VI of the proposed protocol amends Article 7 (Income from Real Property) of the treaty in order to clarify that the treaty's rules allowing the taxation of gain on real property and real property interests are fully consistent with the provisions of the Foreign Investment in Real Property Act of 1980 (FIRPTA), as amended. Under the new paragraph 3, the United States specifically is permitted to tax gains derived by a resident of Israel from the disposition of any "U.S. real property interest," or the disposi-

---

[9] United States Treasury Department, *Technical Explanation of the Second Protocol Amending the Convention Between the Government of the United States of America and the Government of the State of Israel with Respect to Taxes on Income, Signed on January 26, 1993,* October 1993.

[10] Sec. 5(a) of the United States-Israel Free Trade Area Implementation Act of 1985 (P.L. 99-47) provides that the statutory laws of the United States (including the Internal Revenue Code) shall prevail over any conflicting provisions of the U.S.-Israel Free Trade Area Agreement. Accordingly, nothing in the U.S.-Israel Free Trade Area Agreement inhibits the effect of provisions in the Internal Revenue Code, whether enacted before or after the U.S.-Israel Free Trade Area Agreement entered into force, that may treat expenses incurred within that country more favorably than expenses incurred in the other treaty country.

tion of an interest in a partnership, trust or estate to the extent attributable to a U.S. real property interest. Israel is permitted to tax gains derived by a resident of the United States from the disposition of a comparable interest in real property in Israel. According to the Technical Explanation, the term "U.S. real property interest" is understood by the United States and Israel to have the same meaning in the treaty as it has in section 897 of the Code. Therefore, as amended by the proposed protocol, the treaty does not limit the Code's provisions for the taxation of foreign interests in U.S. real property.

Article VII. Dividends

Under the treaty, dividends paid by a company that is a resident of one treaty country to a resident of the other country may be taxed by the second country. Such dividends may also be taxed by the first country (the "source country"). However, the tax so charged by the source country may not exceed (a) 12.5 percent of the gross amount of direct-investment dividends (i.e., where the recipient of the dividends is a company that owns at least 10 percent of the voting stock of the company paying the dividends, and the paying company satisfies certain other qualifications), or (b) 25 percent of the gross amount of the dividends in all other cases.[11]

The proposed protocol first clarifies that the prohibition of source country tax in excess of 12.5 percent on certain direct-investment dividends applies to dividends paid to U.S. companies and to Israeli companies.

Second, under the proposed protocol, the prohibition of source country tax in excess of 12.5 percent on certain direct-investment dividends does not apply to a dividend from a United States Regulated Investment Company (RIC) or a Real Estate Investment Trust (REIT). The proposed protocol allows the United States to impose a 25-percent tax on a U.S. source dividend paid by a RIC to any Israeli company, even if the Israeli company owns 10 percent or more of the voting shares of the RIC. The proposed protocol, like the treaty, limits to 25 percent the U.S. tax that may be imposed on a U.S. source dividend paid by a REIT to an individual resident of Israel who holds a less than 10 percent interest in the REIT. However, there would be no limitation, under the proposed protocol, on the tax that may be imposed by the United States on a dividend paid by a REIT to an Israeli resident if the recipient is either an individual holding a 10-percent-or-greater interest in the REIT, or a company. Thus, such a dividend is taxable by the United States, under current domestic law, at the full 30-percent rate.

Third, Article VII of the proposed protocol provides that the limitation on source country taxation of dividends does not apply to taxes imposed by Israel on dividends paid by certain Israeli companies to U.S. investors. The Israeli companies subject to this exception are those taxed as pass-through entities under sections 64 (House property companies) and 64A (Family companies) of the Israeli Income Tax Ordinance, or in a substantially similar manner. As explained in paragraph 9 of the Exchange of Notes, examples

[11] The staff understands that certain tax incentives are available under Israeli law under which withholding tax rates on dividends paid to foreign investors may be reduced from 25 percent to as low as 15 percent, without regard to any bilateral tax treaty.

of pass-through taxation under Israeli law include a corporation that is itself exempt from tax with the shareholders taxable on their pro-rata shares of the corporation's income, or a corporation that is entitled to a deduction for dividends paid to shareholders. Dividend income covered by this exception is treated as if it were business profits from a permanent establishment in Israel, and therefore taxable on a net basis in Israel.

Article VIII. Interest

Article VIII of the proposed protocol adds two new paragraphs to Article 13 (Interest) of the treaty. The first new paragraph offers an election to a treaty resident receiving interest income from sources in the other treaty country. Instead of being subjected to gross basis tax in the source country (at rates not to exceed 10 percent in the case of interest on a loan from a bank or other financial institution, or 17.5 percent in the case of other interest), the treaty resident may elect to be taxed on a net basis as if the interest income were industrial and commercial profits attributable to a permanent establishment in the other treaty country, and taxable under Article 8 (Business Profits) of the treaty. The proposed protocol authorizes the competent authorities of each country to adopt reasonable rules for the determination and reporting of such net-basis taxable income, as well as procedures to ensure that the treaty resident deriving interest income from the source country makes available to the tax authorities of the source country such books and records as are necessary to determine the proper amount of the tax. The Technical Explanation states that the U.S. competent authority will provide rules for the apportionment of expenses for purposes of determining the amount of net income on which the United States would impose tax at the source, as is required for income taxable under Article 8 (Business Profits).

The second new paragraph of Article 13 of the treaty, added by Article VIII of the protocol, provides that the treaty's reductions and exemptions for withholding tax on interest do not apply to any excess inclusion with respect to a residual interest in a real estate mortgage investment conduit (REMIC). The effect of this provision is to permit the source country to impose its full statutory rate of withholding tax on that type of income. This provision is consistent with the tax policy embodied in Code sections 860E(e) and 860G(b), that excess inclusions with respect to a REMIC should bear a full U.S. tax in all cases. The Technical Explanation suggests that, without a full source-basis tax imposed on such amounts of income, Israeli purchasers of residual interests would have a competitive advantage over U.S. purchasers when such residual interests are initially offered for sale, and also that differences in the timing of taxable and economic income produced by these residual interests would create opportunities for tax avoidance.

Paragraph 10 of the Exchange of Notes sets forth an understanding regarding the purpose and application of this second new provision added by Article VIII of the proposed protocol to Article 13 (Interest) of the treaty. The Exchange of Notes recites an understanding that this new provision has been added at the request of the United States to address a problem of domestic tax avoidance arising under the internal laws of the United States, and that the

United States intends to include similar provisions in all of its future treaties. The Exchange of Notes recites an understanding that if the United States were to amend the Internal Revenue Code to eliminate this problem of domestic tax avoidance in a manner other than by imposing tax on the recipient of the excess inclusion with respect to a REMIC, such excess inclusions would from that point be treated as ordinary interest income in the hands of nonresident recipients, and would thus be eligible for the exemption from withholding tax on interest income available under the laws of the United States. Therefore, notwithstanding the provision added by the proposed protocol, interest income earned by a resident of Israel in the form of an excess inclusion with respect to a REMIC would not be subject to tax by the United States. The Exchange of Notes further states that, should the United States fail to include a provision similar to this new paragraph of Article 13 (Interest) in U.S. tax treaties signed subsequent to the entry into force of this treaty, without having amended the Internal Revenue Code to eliminate the domestic tax avoidance problem, that would be considered a change in U.S. treaty policy that would make it appropriate to amend the tax treaty, as described above under Article V of the proposed protocol.

Article IX. Branch Tax

Article IX of the proposed protocol adds Article 14A (Branch Tax) to the treaty. Under this new article, the United States is expressly permitted to impose the branch profits tax and the branch-level interest tax on an Israeli company, as provided under Code section 884.

The Code, as amended by the 1986 Act, imposes branch-level taxes on foreign corporations earning income effectively connected with the conduct of a U.S. trade or business. The Code provides that no U.S. treaty shall exempt any foreign corporation from the branch profits tax (or reduce the amount thereof) unless the foreign corporation is a "qualified resident" of the treaty country.

The Code defines a "qualified resident" as any foreign corporation which is a resident of a treaty country if it can meet either of the following tests. First, any foreign corporation resident in a treaty country is a qualified resident of that country unless (1) 50 percent or more (by value) of the stock of the corporation is owned (directly or indirectly within the meaning of Code section 883(c)(4)) by individuals who are not residents of the treaty country and who are not U.S. citizens or resident aliens, or (2) 50 percent or more of its income is used (directly or indirectly) to meet liabilities to persons who are not residents of the treaty country or the United States. Second, a foreign corporation resident in a treaty country is a qualified resident if the stock of the corporation is primarily and regularly traded on an established securities market in the treaty country, or if the corporation is wholly owned (either directly or indirectly) by another foreign corporation which is organized in the treaty country and the stock of which is so traded, or is wholly owned by a U.S. corporation whose stock is primarily and regularly traded on an established securities market in the United States.

The proposed protocol provides that a company which is a resident of one treaty country may be subject in the other country to

a tax in addition to the tax allowable under the other provisions of the treaty. In the case of the United States, that tax may be imposed only on two amounts. One amount is the "dividend equivalent amount" of the business profits of the company which are effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States and which are either attributable to a permanent establishment in the United States or subject to tax in the United States under Article 7 (Income from Real Property) or Article 15 (Capital Gains) of the treaty.[12] The other amount is the excess, if any, of interest deductible in the United States in computing the profits of the company that are subject to tax in the United States and are either attributable to a permanent establishment in the United States or subject to tax in the United States under Article 6 or Article 15 of the treaty, over the interest paid by or from the permanent establishment or trade or business in the United States.

Israel does not impose either a branch profits tax or a branch-level excess interest tax comparable to the taxes imposed by the United States under Code section 884. Under the proposed protocol, however, Israel would be permitted to impose branch-level taxes should its domestic laws be amended in the future to impose such taxes. In that event, the proposed protocol would permit Israel to tax an Israeli branch operation of a U.S. corporation in a manner comparable to a similarly situated Israeli corporation and its U.S. shareholder. The proposed protocol does not limit the application of Israel's potential branch tax to permanent establishments, unlike the permissible scope of the U.S. branch-level taxation under the proposed protocol. Paragraph 11 of the Exchange of Notes, however, recites an understanding that should Israel impose a branch tax in circumstances in which the United States is not permitted under the proposed protocol to impose its branch tax, the competent authorities of the two countries will consult with a view toward conforming the rules for branch-level taxation under the treaty.

The proposed protocol limits the rate of branch tax that may be imposed by the two countries. Under the proposed protocol, a treaty country may not impose a branch profits tax at a rate exceeding the rate specified under the treaty for taxes on direct-investment dividends (i.e., 12.5 percent). Similarly, a treaty country may not impose a branch-level interest tax at a rate exceeding 5 percent, which can be viewed as a blend of the rates specified under the

[12] The term "dividend equivalent amount" is not defined in either the treaty or the proposed protocol. The Technical Explanation explains that the term is to be defined in accordance with applicable U.S. internal law (i.e., Code section 884(b) and regulations thereunder), as the term may be amended from time to time without changing the general principle thereof. Generally, the dividend equivalent amount is the earnings and profits of a U.S. branch of a foreign corporation attributable to its income effectively connected (or treated as effectively connected) with a U.S. trade or business, subject to two adjustments. These adjustments identify changes in a branch's U.S. net equity (i.e., the difference between a branch's assets and liabilities treated as connected with a U.S. trade or business) that reflect the uses to which the profits are put during a taxable year. The first adjustment reduces the tax base to the extent the branch's earnings are reinvested in trade or business assets in the United States (or reduce U.S. trade or business liabilities). The second adjustment increases the tax base to the extent prior reinvested earnings are withdrawn from the U.S. or business, such as by remittance to the home office of the foreign corporation.

treaty and the proposed protocol[13] for taxes on various types of interest.

Paragraph 11 of the Exchange of Notes also recites an understanding that a treaty-country resident that qualifies for benefits under the treaty (i.e., taking into account the limitations of treaty Article 25 (Limitation on Benefits), as added by Article XII of the proposed protocol) will not be subject to branch-level taxation except as authorized by the treaty. This understanding means simply that the determination of a treaty resident that qualifies for treaty benefits under Article 25 of the treaty will take precedence over the definition of qualified residence for branch tax purposes under Code section 884(e)(4).

Article X. Capital Gains

Article X of the proposed protocol makes three amendments to Article 15 (Capital Gains) of the treaty. Article 15 generally provides that a resident of one treaty country is exempt from tax by the other treaty country on gains from the sale, exchange, or other disposition of capital assets, except as provided in several enumerated exceptions.

The proposed protocol's first amendment to Article 15 clarifies the enumerated exception under which certain gains on real property located in the second treaty country may be taxed by that country. As modified by the proposed protocol, this exception applies to precisely those gains on which taxation is permitted to be imposed under Article 7 (Income from Real Property) of the treaty.

The proposed protocol's second amendment to Article 15 pertains to the enumerated exception (under which taxation by the source country is permitted) for certain direct-investment stock gains. Article 15 of the treaty permits Israel to tax gains derived by a resident of the United States from the disposition of stock in an Israeli corporation, if within the 12-month period preceding the disposition the U.S. resident owned (actually or constructively) stock possessing more than 50 percent of the voting power of the Israeli corporation, and if at certain dates in the preceding years, more than 50 percent of the fair market value of the Israeli corporation's gross assets used in its trade or business were physically located in Israel. The proposed protocol amends Article 15 of the treaty to permit the taxation of direct-investment stock gains by the source country on a reciprocal basis, (i.e., by the United States as well as by Israel), and to substantially reduce the ownership threshold for the allowance of taxation. As amended by the proposed protocol, Article 15 of the treaty does not apply its general exemption from source country taxation of gains (i.e., permits source country taxation of such gains), in a case where the gain is derived by a resident of one treaty country from the sale, exchange or other disposition of stock in a corporation of the second treaty country, if the resident of the first treaty country owned, directly or indirectly, at any time within the twelve-month period preceding such transaction, stock possessing 10 percent or more of the voting power of the corporation. Paragraph 12 of the Exchange of Notes clarifies

[13] Under the net-basis election provided by Article VIII of the proposed protocol, taxation of interest income by the source country may be imposed at levels equivalent to very low rates of gross-basis tax.

that direct or indirect ownership includes constructive ownership through related persons, for purposes of the entire Article 15 of the treaty.

Although this amendment permits direct-investment stock gains to be taxed on a reciprocal basis, in contrast to the allowance of such taxation only by Israel in the treaty prior to amendment by the proposed protocol, no additional taxation is imposed by the United States under the current provisions of the Internal Revenue Code. Under the Code, gain realized by a nonresident alien or a foreign corporation from the sale of a capital asset (other than certain interests in U.S. real property) generally is not subject to U.S. taxation unless either the gain is effectively connected with the conduct of a U.S. trade or business, or, in the case of a nonresident alien individual, the individual is physically present within the United States for at least 183 days in the taxable year. Thus, unless the Code is amended, no tax is imposed by the United States on direct-investment stock gains in U.S. companies realized by residents of Israel.

The proposed protocol's third amendment to Article 15 pertains to the application of the direct-investment stock gains provision in the case of certain corporate transactions involving the transfer of the stock or assets of a corporation of one treaty country that owns stock in a corporation of the second treaty country. This new provision of Article 15 of the treaty applies in a case where the transferor corporation and the transferee corporation are both resident in the same treaty country, where the transferor or the transferee owns, either directly or indirectly, stock representing 80 percent or more of the voting rights and value of the other corporation (or a third corporation resident in the same treaty country owns such a stock interest in both the transferor and the transferee), and where the transferee's basis in the asset or assets received is determined (in whole or in part) by reference to the transferor's basis in such assets. In such a case, the amount of gain taxable in the second treaty country is limited to the value of cash or other property ("boot") received by the transferor corporation. This limitation does not apply, however, if the first treaty country taxes as gain on the transaction more than the amount of boot received.

For example, assume that Company A and Company B are both incorporated in the United States, and are members of the same affiliated group. Company B owns 10 percent of the stock in Company C, an Israel corporation. Assume further that Company B is merged into Company A in a transaction that is described in section 368(a)(1)(A) of the Internal Revenue Code, and accordingly, Company A's basis in the Company C stock previously held by Company B is determined under section 362(b) of the Code by reference to the basis of the Company C stock in the hands of Company B. Under Article 15 of the treaty, as amended by Article X of the proposed protocol, Israel is permitted to tax the gain realized by Company B on the transfer of its Company C stock to Company A only to the extent of any boot received by Company B.

Article XI. Governmental Functions

Article XI of the proposed protocol clarifies the meaning and operation of Article 22 (Governmental Functions) of the treaty by

adding new paragraphs to that article to define public funds and public employment. The treaty reserves to a treaty country the right to tax amounts paid to certain persons from public funds of that country for service performed as an employee of the national government of that country or an agency thereof, in the discharge of functions of a governmental nature. Under Article 22 as amended, public funds are defined to mean the funds of (a) the treaty country itself, or a political subdivision or local authority thereof, (b) a corporation wholly owned by such a governmental body that performs functions of a governmental nature, or (c) any other body that is treated for tax purposes under the laws of the treaty country in the same manner as such a governmental body, and that performs governmental functions.

Under Article 22, as amended, employment by a treaty country is defined to include employment by any entity the funds of which are treated as public funds under the definition described above.

Article XII. Limitation on Benefits

In general

Article XII of the proposed protocol replaces Article 25 (Investment or Holding Companies) of the treaty with a new Article 25 captioned "Limitation on Benefits." This provision, in a much more sophisticated manner than the treaty's investment or holding companies provision, is intended to limit indirect use of the treaty by persons who are not entitled to its benefits by reason of residence in the United States or Israel.

The treaty is intended to limit double taxation caused by the interaction of the tax systems of the United States and Israel 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" and refers to the situation where a person who is not a resident of either country seeks certain benefits under the income tax treaty between the two countries. Under certain circumstances, and without appropriate safeguards, the nonresident is able indirectly to secure these benefits by establishing a corporation (or other entity) in one of the countries; the entity, as a resident of that country, is entitled to the benefits of the treaty. Additionally, it may be possible for the third-country resident to reduce the income base of the treaty-country resident by having the latter pay out interest, royalties, or other amounts under favorable conditions (i.e., it may be possible to reduce or eliminate taxes of the resident company by distributing its earnings through deductible payments or by avoiding withholding taxes on the distributions), either through relaxed tax provisions in the distributing country or by passing the funds through other treaty countries (essentially, continuing to treaty shop), until the funds can be repatriated under favorable terms.

The proposed new anti-treaty-shopping article provides that a resident of a treaty country generally is not entitled to the benefits of the treaty if it fails an ownership/"base erosion" test or a disproportionate-ownership test. These tests do not apply, however, and treaty benefits are available, if the treaty resident satisfies one of five specific exemptions from the ownership/"base erosion" and

disproportionate ownership tests. The proposed protocol also authorizes the competent authorities of the treaty countries to provide additional exemptions.

Ownership/base-erosion test

Under the proposed protocol, as under one proposal provision of the U.S. model and corresponding provisions of recent U.S. treaties, a person would fail the ownership/base-erosion test if that person fails either the ownership branch or the base-erosion-payments branch of the test.

Under the ownership branch of the ownership/base-erosion test, treaty benefits are not available if 50 percent or more of the beneficial interest (in the case of a company, 50 percent or more of the voting power or value of the company's stock) in that entity is owned directly or indirectly by any combination of one or more individuals who are not residents of Israel or the United States, and who are not citizens of Israel or the United States taxable in that country on income derived outside that country.

In addition, under the base-erosion-payments branch of the test, treaty benefits are not available if 50 percent or more of the gross income of the entity is used (i.e., in substantial part), directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons or entities who are residents of a third country (other than the United States or Israel), and who are not citizens of Israel or the United States who are taxable in that country on income derived outside that country. This rule is commonly referred to as the "base erosion" rule and is necessary to prevent a corporation, for example, from distributing (including paying, in the form of deductible items such as interest, royalties, service fees, or other amounts) most of its income to persons not entitled to benefits under the treaty. This provision is similar to those in recent U.S. treaties.

Disproportionate-ownership test

Under the disproportionate-ownership test, treaty benefits are not available in a case where the treaty resident company (or another company, wherever resident, that controls the treaty resident company) has outstanding a class of stock that entitles its holders (by a dividend distribution or by any other means) to a disproportionately high share of the income derived in the other treaty country from assets located there or activities conducted there, if 50 percent or more of the shares of that class of stock are owned directly or indirectly by any combination of one or more individuals who are not residents of Israel or the United States, and who are not citizens of Israel or the United States taxable in that country on income derived outside that country. This test prevents third-country residents from claiming the benefits of the treaty through the use of so-called "alphabet" stock. For example, assume that a U.S. holding company (of which more than 50 percent of the vote and value of all classes of stock is owned by U.S. resident individuals) has outstanding a second class of stock, class I stock, which entitles its holders to all dividends received by the U.S. holding company from its subsidiary that is incorporated in and operating exclusively in Israel. The disproportionate-ownership test makes it

clear that third-country residents who structure their investment in the Israeli corporation through ownership of class I stock in the U.S. holding company do not thereby effectively obtain the benefits of the treaty's reduced source taxation of dividends paid by an Israeli corporation.

Specific exemptions

As noted above, these tests do not apply, and treaty benefits are available, if the treaty resident satisfies one of five specific exemptions from the ownership/base-erosion and disproportionate-ownership tests. The first specific exemption applies if the treaty resident is an individual.

The second specific exemption applies if the treaty resident is itself one of the treaty countries or a political subdivision or local authority thereof, or if the treaty resident is a corporation wholly owned by such a governmental body that performs governmental functions, or if the treaty resident is any other body that is treated for tax purposes in the same manner as such a governmental body and that performs governmental functions. This exemption applies to entities that are described in treaty Article 22 (Governmental Functions), as amended by Article XI of the proposed protocol.

The third specific exemption applies if the treaty resident is engaged in the active conduct of a trade or business in its residence country, and the income derived from the other country is derived in connection with, or is incidental to, that trade or business. However, this exemption does not apply (and the availability of treaty benefits is thus subject to the ownership/"base erosion" and disproportionate-ownership tests) to the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company. This active trade or business rule replaces a more general rule in some earlier U.S. income tax treaties that preserves benefits if an entity is not used "for a principal purpose of obtaining benefits" under a treaty.

The Technical Explanation states that the situations intended to be covered by this "active business" exemption are those illustrated in the first six examples in the Memorandum of Understanding Regarding the Scope of the Limitations on Benefits Article in the Convention Between the Federal Republic of Germany and the United States of America.[14] For example, a dividend paid to a U.S. manufacturing company by its Israeli sales subsidiary that is selling the parent's products in Israel would be considered "derived in connection with" the U.S. company's active trade or business. As another example, dividends earned by an Israeli corporation from investing some of its working capital, temporarily, in U.S. preferred shares would be considered "incidental to" its active trade or business. Even if the Israeli company has no other activities in the United States, the dividends from those shares would be considered incidental to the active business of the company in Israel, and would be entitled to U.S. treaty benefits.

The fourth specific exemption applies if the treaty resident satisfies a public-company test. Under the public-company test, a com-

---

[14] See *Tax Convention with the Federal Republic of Germany*, Sen. Exec. Rept. No. 101-27, 101st Cong., 2d Sess. 79-80 (1990).

pany that is a resident of Israel 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. The term "recognized stock exchange" includes 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 Tel Aviv stock exchange and any other Israeli stock exchange that may be approved by the Minister of Finance; and any other stock exchange agreed upon by the competent authorities of the two countries.

The fifth and last specific exemption applies if the treaty resident is a tax-exempt organization that also satisfies a geographical-participation test. This exemption applies to any 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 the beneficiaries, members, or participants, if any, in the organization are entitled to the benefits of the treaty. The Technical Explanation states that the organizations intended to be covered by this exemption include pension funds, pension trusts, private foundations, trade unions, trade associations, and similar organizations. For example, an Israeli pension fund that provides pension benefits primarily to residents of Israel would be entitled to treaty benefits under this exemption with respect to its investment income from sources in the United States.

Competent authority

Finally, the proposed protocol provides a "safety-valve" for a treaty-country resident that has not established that it meets one of the above objective tests (i.e., the ownership/base-erosion test, the disproportionate-ownership test, or one of the five specific exemptions), 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 Technical Explanation states an understanding that the competent authorities will take all relevant facts and circumstances into account in making such a determination. The Technical Explanation states that such factual criteria are expected to include the existence of a clear business purpose for the structure and location of the income earning-entity in question, the conduct of an active trade or business (as opposed to mere investment activity) by the entity, and a valid business nexus between that entity and the activity giving rise to the income. In this regard, for example, paragraph 13 of the Exchange of Notes recites an understanding that the competent authority may be expected to grant treaty benefits under this authority in a case where a treaty resident fails the base-erosion-payments branch of the ownership/base-erosion test solely by reason of a bona fide loan from a third-country financial institution.

The Technical Explanation also states an expectation that a taxpayer will be permitted to request an advance determination from

the competent authority on the basis of the taxpayer's facts and circumstances, rather than being required to wait until benefits under the treaty are denied on the basis of the objective tests of the limitation-on-benefits article. In addition, the Technical Explanation states an expectation that treaty benefits allowed by the competent authority will be allowed retroactively (to the later of the entry into force of the relevant treaty provision, or the establishment of the structure in question).

This provision is similar to a portion of the qualified resident definition under the Code's branch tax rules, under which the Secretary of the Treasury may, in his sole discretion, treat a foreign corporation as being a qualified resident of a foreign country if the corporation establishes to the satisfaction of the Secretary that it meets such requirements as the Secretary may establish to ensure that individuals who are not residents of the foreign country do not use the treaty between the foreign country and the United States in a manner inconsistent with the purposes of the Code rule.

The proposed protocol also provides that, in any case where one treaty country proposes to deny treaty benefits to a resident of the other treaty country by reason of the new "limitation on benefits" article, the two competent authorities shall consult each other upon request by one competent authority.

In addition, the proposed treaty article provides that the competent authorities shall consult together with a view to developing a commonly agreed application of this article. Paragraph 14 of the Exchange of Notes expands this obligation, stating that the two competent authorities will develop an agreed Memorandum of Understanding intended to give guidance to both taxpayers and tax authorities of the United States and Israel in interpreting the "limitation on benefits" article. Paragraph 14 of the Exchange of Notes further states that the competent authorities may develop and publish further understandings and interpretations as experience is gained in administering the treaty.

It may be that any corporation that satisfies the limitation-on-benefits article of the proposed treaty generally also will meet the definition of "qualified resident" for branch profits tax purposes in the Code. For example, an Israeli corporation qualifies for treaty benefits under the protocol if there is substantial and regular trading of its principal class of stock on a recognized stock exchange, while that corporation would not meet the 1986 Act's public company test unless such company's stock were *primarily* traded on an established securities market (or the corporation were wholly owned by another corporation whose stock were primarily so traded). It may be that, for practical purposes, those tests could be interpreted in substantially the same fashion. Also, although it is unlikely, an Israeli corporation that met the active-business test might conceivably fail whatever tests the Secretary promulgated under Code section 884(e)(4)(C).

Article XIII. Relief From Double Taxation

Article XIII of the proposed protocol makes four amendments to Article 26 (Relief From Double Taxation) of the treaty.

First, the proposed protocol deletes from the treaty special rules pertaining to the application of U.S. foreign tax credits to an

amount (treated as a tax under the treaty) with respect to a compulsory loan to Israel. On account of the elimination of the compulsory loan rules under Israeli law, this treaty provision is no longer necessary.

Second, the proposed protocol provides specific rules for the application of foreign tax credits in the case of a U.S. citizen who resides in Israel. In such a case, Israel is obligated to provide credits for U.S. tax only to the extent of the tax that the United States would be permitted to impose on U.S. source income under the treaty if the Israeli resident were not a citizen of the United States. The United States then provides a credit against U.S. tax for the amount of net income tax paid to Israel after allowance of the credit described in the previous sentence. The foreign tax credit allowed by the United States, however, is to be allowed only against U.S. tax paid on the basis of citizenship, and thus may not reduce the amount of U.S. tax for which Israel is required to allow a foreign tax credit. Merely requiring the United States to allow a foreign tax credit for taxes paid to Israel on such U.S. source income would not be effective to relieve double taxation, however, because foreign tax credits are only usable to the extent that the U.S. taxpayer has foreign source income. Therefore, the proposed protocol provides that the U.S. source income on which the United States is required to allow foreign tax credits shall be deemed to arise from sources in Israel to the extent necessary to avoid double taxation. Inasmuch as this resourcing applies only to the extent necessary to avoid double taxation, no excess foreign tax credits will result that can be used against U.S. tax on any other item of income.[15]

Third, the proposed protocol clarifies that the foreign tax credit that Israel is required to allow for certain taxes paid or incurred to the United States is to be allowed in accordance with and subjected to the limitations of the law of Israel, as it may be amended from time to time without changing the general principles set forth in the treaty article. Thus, as with the provisions of U.S. tax treaties that guarantee the allowance of a foreign tax credit by the United States, the foreign tax credit required by the treaty is subject to the foreign tax credit limitations and other provisions of present domestic law, and is also subject to provisions adopted in the future, so long as such future domestic provisions are consistent with the treaty principle of providing a foreign tax credit.

Fourth, the proposed protocol adds a new provision to Article 26 (Relief from Double Taxation) of the treaty pertaining to the application of the source rule of Article 4 (Source of Income) of the treaty for foreign tax credit purposes. The proposed protocol provides that Article 4's source rule for income from the disposition of stock, or of interests in an intangible, applies for all foreign tax credit purposes under Article 26, notwithstanding any other provision of the treaty or of domestic law. This rule, therefore, is not subject to the saving clause of treaty Article 6 (General Rules of Taxation),

[15] Israel offers an additional method for a foreign investor to avoid generating excess foreign tax credits from business activities in Israel, which generally imposes higher levels of taxation than the United States. The Minister of Finance is authorized to grant a refund, in whole or in part, of Israeli income tax imposed on a nonresident investor with respect to income earned or derived from sources in Israel to the extent that the Israeli income tax exceeds the foreign tax credit available in the investor's country of residence. Income Tax Ordinance, sec. 16A.

and thus takes precedence over the Internal Revenue Code as applied to U.S. citizens as well as residents of Israel.

Paragraph 15 of the Exchange of Notes recites an understanding that for U.S. foreign tax credit purposes, the terms "stock" and "intangibles" are limited to those interests for which an election relating to foreign tax credit relief is provided under U.S. law. The Technical Explanation explains that this is a specific reference to section 865(h) of the Code. That provision, in turn, may apply to a gain from the sale of either stock in a foreign corporation, or a type of intangible property defined in Code section 865(d)(2), which gain is treated as U.S. source income under section 865 of the Code, but is treated as foreign source income under a treaty. Code section 865(h) provides that in such a case, if an election is made, the gain will be treated as foreign source, but subject to a separate foreign tax credit limitation. According to the Technical Explanation, if a foreign tax credit is claimed applying the source rule added by the proposed protocol, the credit allowed is computed separately with respect to that item of gain.

The proposed protocol provides that the other source rules set forth in Article 4 of the treaty also apply for purposes of the foreign tax credit allowed under Article 26 of the treaty, but only to the extent not prohibited by the domestic law of the treaty country that is providing relief from double taxation. Thus, for example, the special source rules for foreign tax credit purposes provided under section 904(g) of the Code will apply to income that would otherwise be treated, under the treaty, as income from Israeli sources.[16]

Article XIV. Nondiscrimination

Article XIV of the proposed protocol makes two amendments to Article 27 (Nondiscrimination) of the treaty. The first amendment replaces the treaty's prohibition of discrimination by one country against its residents who are citizens of the other treaty country, regardless of residence with the broader provision that is contained in the 1981 U.S. model treaty. Under this revised nondiscrimination rule, citizens of one treaty country, regardless of residence, may not be subjected in the other treaty country to any taxation or connected requirement which is other or more burdensome than the taxation and connected requirements to which citizens of the other country in the same circumstances may be subjected. The proposed protocol also states explicitly that, for purposes of U.S. tax, a U.S. citizen who is not a resident of the United States is not in the same circumstances as an Israeli citizen who is not a resident of the United States. This is because the U.S. citizen is subject to U.S. tax on worldwide income, while a citizen of Israel who is not a U.S. resident is subject to U.S. tax only on certain items of income with a sufficient nexus to the United States. The fact that an Israeli citizen who is not a resident in the United States is not treated as in the same circumstances as a U.S. citizen who is not a resident in the United States means that the United States need not apply the same taxing regime to an Israeli citizen who is

[16] The proposed protocol also provides a special rule clarifying that the treaty does not override section 904(g) of the Code, notwithstanding that the fact that the treaty will enter into force after the enactment of section 904(g). This rule is provided in Article XVII of the proposed protocol, and discussed below.

not a resident in the United States that it applies to a U.S. citizen who is not resident in the United States.

Second, the proposed protocol specifies that the nondiscrimination rules of Article 27 shall not be construed to prevent either treaty country from imposing branch-level taxation as allowed in Article 14A (Branch Tax) of the treaty. Thus, without addressing the question of whether a branch tax as described under Article 14A should properly be viewed as discriminatory under the language contained in Article 27, the proposed protocol provides that branch-level taxation as described in Article 14A is not subject to any limitation or restriction under Article 27.

In addition, the Technical Explanation states that certain understandings were reached during the course of negotiations of the proposed protocol regarding the application of Article 27 to two aspects of U.S. tax laws. Section 1446 of the Code imposes on any partnership with income that is effectively connected with the conduct of a U.S. trade or business the obligation to withhold tax on amounts allocable to a foreign partner. In the context of the treaty, this obligation applies with respect to that portion of partnership income attributable to a permanent establishment in the United States, to the extent that portion is allocable to a partner resident in Israel. There is no similar obligation with respect to the distributive share of a partner resident in the United States. The Technical Explanation recites an understanding that this distinction between a U.S. resident partner and an Israeli resident partner is not a form of discrimination within the meaning of Article 27 of the treaty. No distinction is made between U.S. and Israeli partnerships, inasmuch as the law requires that tax be withheld in respect of the distributive shares of non-U.S. partners regardless of the domicile of the partnership itself. In distinguishing between U.S. and Israeli partners, the requirement to withhold on the share of the Israeli partner, but not the U.S. partner, does not constitute discriminatory taxation; rather, it is considered a reasonable method for the collection of tax from persons who are not continually present in the United States, and as to whom it otherwise may be difficult for the United States to enforce its tax jurisdiction. Like all other types of withholding, if the tax is overwithheld, the partner can file for a refund.

The second understanding pertains to section 367(e)(2) of the Code, added by the Tax Reform Act of 1986 (the "1986 Act"), which changed the rules for taxing corporations on certain distributions made in liquidation. The 1986 Act amended U.S. tax law generally so as to require corporations to be taxed on distributions of appreciated property in complete liquidation.

The Code provides an exception to the foregoing rule in the case of distributions and liquidations by 80-percent-or-more controlled subsidiaries to their parent corporations. This exception is permitted because the untaxed appreciation in the assets is recognized when the parent sells or distributes the assets. For this reason, this exception does not apply to distributions to parent corporations that are themselves either tax-exempt organizations or, except to the extent provided in regulations, foreign corporations. The principle of tax policy embodied in this provision is that one level of tax should be imposed at the corporate level on a liquidating distribu-

tion of appreciated property, so that the tax is permitted to be deferred only in cases where a subsequent sale or distribution of the appreciated property will result in corporate-level taxation. On this basis, the Technical Explanation recites an understanding that the inapplicability of this exception to the taxation of liquidation distributions in the case of foreign parent corporations does not conflict with Article 27 of the treaty. The Technical Explanation explains that this provision does not constitute discrimination among corporate taxpayers on the basis of foreign rather than U.S. stock ownership, which is prohibited under the rules of Article 27. Eligibility for the exception to the tax on liquidating distributions is available to taxable U.S. corporate parents not on the basis of the nationality of the owners of the distributing corporation, but rather on the basis of whether or not such owners would be subject to corporate tax on a subsequent sale or distribution of the distributed property. Tax-exempt organizations and foreign corporations generally are not subjected to such taxation, so they are not entitled to the exception.

Article XV. Exchange of Information

Article XV of the proposed protocol amends Article 29 (Exchange of Information) of the treaty so as to bring the treaty's rules for the permissible use of exchanged information into conformity with the corresponding provisions of the U.S. model treaty and other recent U.S. tax treaties. Specifically, under the proposed protocol, information that is exchanged under the authority of the treaty is permitted to be disclosed to persons or authorities concerned with the administration of the taxes that are the subject of the treaty. The Technical Explanation states that this provision permits otherwise confidential information to be received by, for example, the tax-writing committees of Congress and the General Accounting Office for their use in the performance of their roles in overseeing the administration of the tax laws.

Article XVI. Amendment to Treaty Provision on Entry into Force

Article XVI of the proposed protocol amends Article 31 (Entry into Force) of the treaty, providing a new rule for the effective date of the treaty with respect to taxes other than withholding taxes. Under the treaty, the beginning of the year for which the treaty becomes effective with respect to taxes other than withholding taxes can only *follow* the date on which the treaty enters into force. Under the proposed protocol, the treaty may take effect with respect to such taxes for a year beginning *earlier* than the date on which the treaty enters into force, depending on the date within the calendar year on which the treaty enters into force. If the treaty enters into force prior to July 1 of that year, the treaty would become effective with respect to taxes other than withholding taxes for taxable years beginning on or after January 1 of that year. If the treaty enters into force after June 30 of any calendar year, the treaty would become effective with respect to taxes other than withholding taxes for taxable years beginning on or after January 1 of the following year. Therefore, if the treaty enters into force prior to July 1, 1994, its provisions will be effective with respect

to taxes other than withholding taxes in taxable years beginning on or after January 1, 1994.

Under Article 31 of the treaty, which is not amended by the proposed protocol, the treaty provisions respecting the rates of taxes collected by withholding will apply to amounts paid on or after the first day of the second month following the date on which the treaty enters into force. The treaty will enter into force 30 days after the date of exchange of instruments ratification by the United States and Israel.

Article XVII. Entry into Force of the Protocol

The proposed protocol will enter into force 30 days after the exchange of instruments of ratification. It will be effective in accordance with the provisions of Article 31 (Entry into Force) of the treaty (as modified by the proposed protocol), as described above.

Article XVII of the proposed protocol provides one exception to the effective date of the treaty. One portion of the first paragraph of Article 26 of the treaty, which is not amended by the proposed protocol, specifies the application of the treaty's source rules for purposes of applying the foreign tax credit of a U.S. person with respect to taxes paid to Israel. As described above in connection with Article XIII of the proposed protocol, the proposed protocol adds a new paragraph to Article 26 of the treaty that provides more specificity as to the application of the treaty's source rules for purposes of the foreign tax credit rules of either treaty country.

The proposed protocol treats the reference to the treaty's source rules in the first paragraph of Article 26 of the treaty as if it had entered into force on May 30, 1980. Therefore, those rules do not take precedence over any later-enacted statutory provision (such as Code sec. 904(g)) that was intended by Congress to apply notwithstanding contrary provisions of pre-existing treaties. Were the reference to the treaty's source rules in the first paragraph of Article 26 treated as entering into force under the general provisions of Article XVII of the proposed protocol and Article 31 of the treaty, it might not be considered to be a pre-existing treaty provision for purposes of the application of section 904(g). The staff understands that the rules provided in paragraph 4 of treaty Article 26, as added by Article XIII of the proposed protocol, are intended to supersede the reference to the treaty's source rules in the first paragraph of Article 26. Thus, the application of the rules provided in paragraph 4 of treaty Article 26 is not to be limited or affected in any way by the reference to the treaty's source rules in the first paragraph of Article 26.

Exchange of Notes

Each paragraph of the Exchange of Notes that pertains to an article in the proposed protocol, or to an article of the treaty itself which is amended by the proposed protocol, is described above in connection with the article of the proposed protocol to which it pertains. Two paragraphs of the Exchange of Notes pertain to treaty articles that are not amended by the proposed protocol, and therefore are not described above.

Paragraph 8 of the Exchange of Notes pertains to Article 10 (Grants) of the treaty. That article provides for U.S. tax exemption

of certain Israeli qualifying cash grants to U.S. residents; but qualifying cash grants do not include any amount which in whole or part, directly or indirectly, is taxed by Israel. Paragraph 8 of the Notes recites an understanding that a grant shall not be considered to be "taxed by Israel" solely by reason of the fact that the grant is not included in the basis of stock or assets for Israeli income tax purposes.

Paragraph 16 of the Exchange of Notes clarifies that any reference in the treaty to the currency of one of the treaty countries is deemed to refer to the legal tender of that country as it may be renamed or replaced from time to time. Thus, the references in Articles 18 (Public Entertainers) and 24 (Students and Trainees) of the treaty to the Israeli pound should be understood currently to be a reference to the Israeli shekel.

APPENDIX:

Description of the Tax Treaty with Israel (Not Yet Ratified), as Modified by the First Protocol (Not Yet Ratified)

REPRINTED FROM THE SENATE FOREIGN RELATIONS COMMITTEE REPORT ACCOMPANYING THE PROPOSED TREATY AND PROTOCOL,[1] TAX CONVENTION (AND PROPOSED PROTOCOL) WITH THE STATE OF ISRAEL, SEN. EXEC. REPT. NO. 97–29, 97TH CONG., 1ST SESS. 8–29 (1981)

A detailed article-by-article explanation of the proposed tax treaty between the United States and Israel is presented below. The explanation includes a discussion of the protocol under the treaty articles amended by it.

Article 1. Taxes Covered

The proposed treaty applies to the U.S. Federal income taxes imposed under the Internal Revenue Code. As amended by the protocol the proposed treaty also applies to the excise tax levied on insurance premiums paid to foreign insurers (section 4371),[2] but only to the extent that the risk is not reinsured, directly or indirectly with a person other than a resident of Israel or another treaty country. In the case of Israel, it applies to the income tax (including capital gains tax), the company tax and the tax on gains from the sale of land under the land appreciation tax law, the tax on profits levied on banking institutions and insurance companies under the value added tax law. These taxes are considered creditable income taxes under the proposed treaty. (See Article 26.) The proposed treaty also applies to certain compulsory war loans and security loans which are treated as income taxes for purposes of the U.S. foreign tax credit. (See Article 26 (Relief from double taxation)), but only if levied for taxable years ending before April 1, 1988, with respect to corporations that became subject to the loan before April 1, 1977.

The proposed treaty also contains a provision generally found in U.S. income tax treaties to the effect that it will apply to substantially similar taxes which either country may subsequently impose.

Additionally, it is provided that the nondiscrimination provisions (Article 27) of the treaty apply to all taxes at the national level by the United States or Israel.

[1] All references to a "protocol" in the following explanation (unless otherwise indicated) are to the first protocol, which was signed on May 30, 1980.

[2] Unless otherwise stated, all citations herein are to the Internal Revenue Code of 1954.

Article 2. General Definitions

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

The proposed treaty contains a provision contained in the more recent U.S. tax treaties, but not in the most recent draft U.S. model, which, in general accord with section 638 of the Code, specifically includes within the definition of the term "United States" the territorial sea of the United States and the continental shelf of the United States insofar as the exploration and exploitation of natural resources on the continental shelf is concerned. A similar definition of Israel is contained in the proposed treaty. As with all U.S. income tax treaties, the term "United States" does not include Puerto Rico, the Virgin Islands, Guam or any of the possessions or territories of the United States. Thus, those jurisdictions, their citizens and residents are not covered.

The proposed treaty also contains the standard provision that undefined terms are to have the meaning which they have under the applicable tax laws of the country applying the treaty. Where a term is defined in a different manner by the two countries or where its meaning under the laws of either country is not readily determinable, the competent authorities of the two countries may establish a common meaning under the laws of either country is not readily determinable, the competent authorities of the two countries may establish a common meaning for the term in order to prevent double taxation or to further any other purpose of the treaty.

Article 3. Fiscal Residence

The benefits of the proposed treaty generally are available only to residents of the two countries. The proposed treaty defines "resident of Israel" and "resident of the United States," and in addition provides a set of rules to determine residence in the case of an individual with dual residence. This provision of the proposed treaty is based on the fiscal domicile article of the OECD model treaty and is similar to the provisions found in other U.S. tax treaties.

An individual whom both countries consider to be a resident according to their general rules for determining residence will be deemed for all purposes of the treaty to be a resident of the country in which he has his permanent home (where an individual dwells with his family), his center of vital interests (his closest economic and personal relations), his habitual abode, or his citizenship. The center of vital interests of an individual who is an "oleh" under the Israel Income Tax Ordinance (i.e., a recent immigrant to Israel) will be deemed to be in Israel. If the resident of an individual cannot be determined by these tests, applied in the order stated, the competent authorities of the countries will settle the question by mutual agreement.

Corporations which qualify as residents of both the United States and Israel will not be entitled to the benefits of the proposed treaty other than those dealing with nondiscrimination (Article 27) and exchange of information (Article 29). Dual residence of a corporation may arise under the proposed treaty where a corporation incorporated in the United States is taxed by Israel as a body of per-

sons resident in Israel. If the treaty were to apply to such corporations, the United States would be obligated to extend to them as residents of Israel the benefits provided by the proposed treaty. Since it is contrary to U.S. tax policy to restrict United States taxation of U.S. corporations, dual resident corporations are removed from the scope of the substantive tax provisions of the proposed treaty. Under the protocol, the source roles (Article 4) and the entry into force (Article 31) also apply to dual resident corporations.

Article 4. Source of Income

The source of income rules are important in view of the general rule in the treaty (Article 6) that one country may tax residents and corporations of the other country only on income from sources within the source country (provided, with certain exceptions, that the resident is not a citizen of the source country). They are also important in view of the fact that the limitation on the foreign tax credit is based on the source of income. Several of the source rules contained in the proposed treaty differ in some degree from the source rules provided in the Internal Revenue Code. Since the general rules of taxation contained in the proposed treaty (Article 6) provide that it will not be applied to increase a person's tax, a taxpayer is not bound to apply the rules described below in calculating his U.S. tax liability.

The proposed treaty provided that dividends will be treated as income from sources within a country only if paid by a corporation of that country.

Under the proposed treaty, interest will be treated as income from sources within a country only if paid by that country, a political subdivision or a local authority thereof, or by a resident of that country. However, interest paid by a permanent establishment (on an indebtedness incurred in connection with the permanent establishment) will be sourced in the country where the permanent establishment is situated. This exception permits one country, under the proper circumstances, to tax interest paid by a permanent establishment maintained in that country by a resident of the other country or by a resident of a third country. For example, if a resident of France has a permanent establishment in Israel which borrows money from a resident of the United States, the interest paid by the Israeli permanent establishment will be deemed to be from Israeli sources and Israel may therefore tax the interest payments but only to the extent allowed by Article 13 (Interest). The United States will not, under the Code (sec. 861(a)(1)(C) and (D)), impose its withholding tax on interest paid to nonresident alien individuals or foreign corporations by a foreign corporation having a permanent establishment in the United States unless the majority of the foreign corporation's gross income from all sources for the 3-year period preceding the payment of the interest was effectively connected with the conduct of a U.S. trade or business.

In addition, the source rule for interest paid by a permanent establishments will operate to exempt interest from tax in the country of the payor's residence if the interest is paid to a resident of the other country by a permanent establishment situated in a third country (and the indebtedness was incurred in connection with the

third country permanent establishment). This results from the restriction in Article 6 (General Rules of Taxation) that a resident of one country who is not a citizen of the other country may be taxed by the other country only on income from sources within that other country.

The proposed treaty provides that royalties for the use of, or the right to use, property or rights defined in the article dealing with royalties will be treated as income from sources within a country only to the extent that such royalties are for the use of, or the right to use, the property or rights within that country.

Income and gains (including mineral royalties) to which the provision relating to income from real property (Article 7) applies will be treated as income from sources within a country only if the real property (or, in the case of a mineral royalty, the underlying real property) is situated in that country.

Income from the rental of tangible personal (movable) property will be treated as income from sources within a country only to the extent that the income is for the use of such property in that country.

Income from the purchase and sale, exchange, or other disposition of intangible or tangible personal property (other than contingent gains described in paragraph (2) of Article 14 (Royalties)) will be treated as income from sources within a country only if such sale, exchange, or other disposition is within that country. However, gains from the sale, exchange, or other disposition of stock in certain Israeli corporation (paragraph (1)(e) of Article 15) will be treated as income from sources within Israel.

Income received by an individual for his performance of labor or personal services, whether as an employee or in an independent capacity, will be treated as income from sources within a country only to the extent that such services are performed in that country. Income from personal services performed aboard ships or aircraft operated by a resident of one country in international traffic will be treated as income from sources within that country if performed by a member of the regular complement of the ship or aircraft. However, compensation described in Article 22 (Governmental Functions) and social security payments (Article 21) will be treated as income from sources within the country making the payments.

Industrial or commercial profits attributable to a permanent establishment will be considered to be from sources within the country in which the permanent establishment is located. This rule also applies to passive income of the types described above in situations where the passive income is treated as industrial or commercial profits because it is effectively connected with the permanent establishment.

The source of any item of income not specified in Article 4 will be determined by each country in accordance with its own law. However, if the source of any item of income under the laws of one country is different from its source under the laws of the other country, or if its source is not readily determinable under the laws of either, the competent authorities of the two countries may, in order to prevent double taxation or further any other purpose of the proposed treaty, establish a common source of the item of income for purposes of the proposed treaty.

Article 5. Permanent Establishment

The proposed treaty contains a definition of permanent establishment which follows the pattern of other recent U.S. income tax treaties and the OECD model tax treaty. However, it differs in some respects to reflect Israel's status as a developing country.

The permanent establishment concept is one of the basic devices used in income tax treaties to avoid double taxation. Generally, a resident of one country is not taxable on its business profits by the other country 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 are applicable.

In general, a fixed place of business through which a resident of one country engages in industrial or commercial activities in the other country is considered a permanent establishment. A permanent establishment includes a branch; an office; a factory; a workshop; a warehouse; a farm or plantation; a store or other sales outlet; a mine, quarry, or other place of extraction of natural resources; any building site, or construction or assembly project (or supervision activity connected therewith and conducted within the country where a site or project is located) which lasts for more than 6 months; and the maintenance of substantial equipment or machinery within the other country for more than 6 months.

The six month period for establishing a permanent establishment in the building site, etc. area is shorter than the 12 month period provided in the most recent draft U.S. model and the OECD model. Also, the maintenance of substantial equipment is not a permanent establishment under the U.S. or OECD models.

This general rule is modified to provide that a fixed place of business which is used for any or all of a number of specified activities will not constitute a permanent establishment. These activities include the use of facilities for storing, displaying, or delivering merchandise belonging to the resident; the maintenance of a stock of goods belonging to the resident for purposes of storage, display, delivery, or processing by another person; and the purchase of goods, collection of information, advertising, scientific research, or other auxiliary activities for the resident. A resident shall not be deemed to have a permanent establishment in the other country merely because the resident sells goods which were displayed at trade fairs or conventions in that other country. The trade fair exception is not intended to apply with respect to goods in the resident's inventory.

A resident of one country will be deemed to have a permanent establishment in the other country if the resident sells in that other country goods or merchandise which were subjected to substantial processing in that country (whether or not purchased there) or were purchased in that country and not subjected to substantial processing outside that country.

A resident of one country will be deemed to have a permanent establishment in the other country if it has an agent in the other country who has, and habitually exercises, a general authority (other than for the purchase of merchandise) to conclude contracts in that other country in the name of the resident. The proposed

treaty contains the usual provision that the agency rule will not apply if the agent is a broker, general commission agent or other agent of independent status acting in the ordinary course of its business.

The determination of whether a resident of one country has a permanent establishment in the other country is to be made without regard to the fact that the resident may be related to a resident of the other country or to a person who engages in business in that other country.

Article 6. General Rules of Taxation

The proposed treaty contains the basic general rules of taxation which are found in most U.S. income tax treaties. A resident of one country may be taxed by the other country only on income from sources within that other country (which includes business profits only to the extent they are attributable to a permanent establishment in that other country). For this purpose, the source rules of Article 4 are to be applied. The proposed treaty also contains the customary rule that it may not be applied to increase the tax burden imposed on residents of either country beyond what it would be in the absence of the treaty—that is, the treaty only applies where it benefits taxpayers.

Additionally, the usual saving clause is contained in the proposed treaty. Under this clause, it is provided that, with certain exceptions, the proposed treaty is not to affect the taxation by the United States or Israel of their citizens or residents. However, the saving clause does not apply in several cases where its application would nullify specific policies contained in the proposed treaty which are designed to benefit residents and citizens of each country. The principal exceptions involved the benefits provided with respect to grants, social security payments, the foreign tax credit, and nondiscrimination. Also, under the proposed protocol, an exception is provided for the provisions dealing with charitable contributions (Article 15-A). The saving clause also does not affect the benefits provided to resident aliens under the provisions relating to diplomatic or consular officers or other governmental employees, teachers, and students, provided they do not have immigrant status in the country imposing the tax.

Similar to certain other U.S. tax treaties, the proposed treaty limits the right of the United States to impose its personal holding company tax and accumulated earnings tax with respect to most Israeli corporations. Under the proposed treaty, an Israeli corporation will be exempt from the personal holding company tax in any taxable year unless U.S. residents or citizens own, directly or indirectly, 10 percent or more in value of the outstanding stock of the corporation at any time during the taxable year. In addition, an Israeli corporation will be exempt from the accumulated earnings tax in any taxable year unless at least 25 percent of its voting stock is owned by U.S. citizens or residents. In the event an Israeli corporation does not satisfy the requirements for exemption under the proposed treaty, it may be subjected to the accumulated earnings tax only with respect to income from sources within the United States (Treas. Reg. sec. 1.532-1(c)).

Article 7. Income from Real Property

The proposed treaty provides that income from real property may be taxed in the country where the real property (including natural resources) is located. Income from real property includes income from the direct use or renting of the property and gains on the sale, exchange, or other disposition of the property. It also includes royalties and other payments in respect of the exploitation of natural resources (e.g., oil wells) and gains on the sale, exchange or other disposition of the royalty rights or the underlying natural resource. Income from real property does not include interest on obligations secured by real property (e.g., mortgages) or secured by natural resource royalties.

Under the proposed treaty as amended by the proposed protocol, gains from the disposition of shares in a corporation the assets of which consists principally of real estate may be taxed in the country in which the real property is located. This preserves the right of the United States to impose its tax on Israeli investors in U.S. real property interests which are corporations as if the treaty did not apply.

Article 8. Business Profits

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

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

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

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

resident broker, commission agent, custodian or other agent or trading by a foreign person physically present in the United States.

Proposed treaty rules.—Under the proposed treaty, industrial and commercial profits of a resident of one country are taxable in the other country only to the extent they are attributable to a permanent establishment which the resident has in the other country. Amounts which are otherwise from sources without a foreign country can be attributable to a permanent establishment in the country. Amounts so attributed are considered sourced in that country for purposes of the proposed treaty. (See Article 4(8).)

In computing the taxable industrial and commercial profits, the deduction of expenses, wherever incurred, which are reasonably connected with the business profits are allowed. Deductible expenses include executive and general administrative expenses. However, in determining the amount of the deduction for head office expenses, the deduction may be limited to the expenses actually incurred by the head office without including a profit element.

The business profits of a permanent establishment are determined on an arm's-length basis. Thus, there is to be attributed to it the industrial or commercial profits which would reasonably be expected to have been derived by it if it were an independent entity engaged in the same or similar activities under the same or similar conditions and dealing at arm's-length with the resident of which it is a permanent establishment.

Industrial and commercial profits will not be attributed to a permanent establishment merely by reason of the purchase of merchandise by the permanent establishment (or by the resident of which it is a permanent establishment) for the account of that resident. Thus, where a permanent establishment purchases goods for its head office, the industrial and commercial profits attributed to the permanent establishment with respect to its other activities will not be increased by a profit element on its purchasing activities.

For purposes of the proposed treaty, the term "industrial or commercial profits" includes income derived from manufacturing, mercantile, banking, insurance, agricultural, fishing or mining activities, the operation of ships or aircraft, the furnishing of services, and the rental of tangible personal (movable) property. The term does not include income from the rental or licensing of motion picture films or films or tapes used for radio or television broadcasting, or income from the performance of personal services derived by an individual either as an employee or in an independent capacity. The tax rules applying to those amounts are contained in other articles. The proposed treaty follows the approach of our other recent tax treaties and the Internal Revenue Code by including within "industrial and commercial profits" investment income (income from dividends, interest, certain royalties, capital gains, and income derived from property and natural resources) where the income is effectively connected with a permanent establishment.

Guidelines are provided for determining what income is effectively connected with a permanent establishment. Factors to be taken into account include whether the rights or property giving rise to the income are used in (or held for use in) carrying on an activity giving rise to industrial or commercial profits through a

permanent establishment and whether the activities carried on through the permanent establishment are a material factor in the realization of the income. For this purpose, due regard will be given to whether or not the property or rights or the income are accounted for through the permanent establishment. The effectively connected concept in this paragraph is substantially similar to the effectively connected concept in the Code (sec. 864(c)).

The proposed treaty, as amended by the protocol, makes clear that the U.S. excise tax on insurance premiums paid to a resident of Israel will be waived whether or not the Israeli is carrying on a business of insurance through a permanent establishment in the United States. This provision applies only if the risk is not reinsured with a person not entitled to this exemption under any tax treaty of the United States.

Article 9. Shipping and Air Transport

The proposed treaty provides that income which is derived by a resident of either country from the operation of ships and aircraft in international traffic and gains which are derived from the sale, exchange or other disposition of such ships or aircraft shall be exempt from tax by the other country. The exemption applies whether or not the ships or aircraft are registered in either country. Accordingly, Israel would not tax the covered shipping income of a U.S. resident from the operation of a Liberian registered ship.

Income from the operation in international traffic of ships or aircraft includes the rental income of ships or aircraft operated in international traffic if the rental income is incidental to income of the resident from the actual operation of ships or aircraft which would qualify for the exemption. For example, this rule permits an airline which is a resident of one country and which has excess equipment during certain periods to lease that excess equipment during those periods to an airline which is a resident of the other country.

The proposed treaty also makes clear that income derived from the use, maintenance, and lease of containers, trailers for the inland transport of containers, and other related container equipment in connection with the operation in international traffic of ships or aircraft is to be included within the scope of the shipping and air transport provision.

Article 10. Grants

This article details the manner in which certain Israeli governmental grants made to U.S. residents will be treated for U.S. tax purposes. Although the provision by its terms is not specifically so limited, it contemplates Israeli governmental grants to U.S. shareholders of Israeli corporations which are made subject to the condition that the U.S. shareholders in turn contribute the grants to the Israeli corporations. The Israeli Government has not established a program under which such grants to U.S. shareholders will be made (although a grant program has been established under which investment incentive grants are made directly to the Israeli corporations).

Under the proposed treaty, as amended by the protocol, the amount of any qualifying cash grant made by Israel (or a political subdivision thereof, or any agency of either) to a U.S. resident will be included in the gross income of the U.S. resident, unless the recipient elects to exclude it. If the resident elects to exclude it and is a corporation, the amount of the grant will be treated as a contribution to its capital. The provision states that the U.S. shareholder will be deemed in turn to pay the grant over to the Israeli corporation, and thus the provision provides that the U.S. shareholder will be considered to have made a capital contribution in the amount of the grant to the Israeli corporation designated by the terms of the grant. In addition, it provides that the U.S. shareholder's basis for the stock of the Israeli corporation will not be increased by the amount of the contributed grant. Also, the basis of property of the Israeli corporation will be reduced by the amount of the deemed contribution. Since the Israeli corporation is deemed to have received the amount of the grant as a contribution to capital by the U.S. shareholder, the provisions of section 362(c) of the Code would not apply to require a reduction in basis of the assets of the Israeli corporation (for purposes of determining the Israeli subsidiary's earnings and profits for U.S. tax purposes). In the absence of this treaty provision, the grant would probably be treated as a nonshareholder contribution to capital by Israel directly to the Israeli corporation, with the result that for U.S. tax purposes the Israeli corporation's basis in its assets would be reduced for U.S. tax purposes by the amount of the grant.

Although the provision could be interpreted to apply to a U.S. resident who acquires assets directly from the proceeds of a grant rather than contributing the grant to an Israeli corporation, the provision would not affect the U.S. resident's tax treatment in such a situation. Thus, for example, if the U.S. resident is a corporation, the rules of section 362(c) of the Code will apply and the corporation will be required to reduce its basis in certain assets acquired after the contribution.

The provision defines a qualifying cash grant as one approved by Israel for investment promotion in Israel. A qualifying grant will not include any amount which in whole or part, directly or indirectly, is in consideration for services rendered or to be rendered by either the shareholder or the Israeli subsidiary, or for the sale of goods. A grant will not qualify if it is measured in any manner by the amount of profits or tax liability of the U.S. shareholder or the Israeli corporation in which the investment is made, and it will not qualify if it is taxed by Israel. A grant will qualify where it is made on the condition that the enterprise meet an approved project's social or economic objectives (which may include, for example, creating employment, generating or conserving foreign exchange, tourism, or developing less-developed regions). It is contemplated that qualifying grants may be made with respect to a particular investment before or after the investment is made and may be based upon whether or not the enterprise has fulfilled the conditions of investment.

Article 11. Related Persons

The proposed treaty, like most other U.S. tax treaties, contains a provision similar to section 482 of the Internal Revenue Code which recognizes the right of each country to make an allocation of income in the case of transactions between related persons, if an allocation is necessary to reflect the conditions and arrangements which would have been made between unrelated persons.

When a redetermination has been made by one country with respect to the income of a related person, the other country will attempt to reach an agreement with the first country in connection with the redetermination and, if it agrees with the redetermination, will make a corresponding adjustment to the income of the other person.

Article 12. Dividends

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

The proposed treaty, as amended by the protocol, limits the rate of withholding tax in the source country on dividends derived by a resident of the other country to 25 percent generally, and to 12.5 percent in the case of dividends paid by a corporation in which the recipient has at least a 10-percent ownership interest, provided not more than 25 percent of the income of the paying corporation consists of dividends and interest other than dividends and interest derived from a banking or other financial business or from a 50-percent or greater owned subsidiary—i.e., that it is not an investment company.

However, a 15-percent rate is allowed by Israel if the income was derived while the corporation was entitled to a tax holiday in Israel.

The reduced rates of tax on dividends will apply unless the recipient has a permanent establishment in the source country and the dividends are effectively connected with the permanent establishment. If the dividends are effectively connected with a permanent establishment, the dividends are to be taxed under the business profits provisions (Article 8). This treatment of dividends generally conforms to that provided by the Internal Revenue Code, other recent U.S. income tax treaties, the U.S. model, and the OECD model tax treaty.

Dividends paid by a corporation of one country to a person other than a resident of the other country (and, in the case of dividends paid by an Israeli corporation, to a person other than a U.S. citizen) will be exempt from tax by the other country. However, this rule is inapplicable if the dividend recipient has a permanent es-

tablishment in that other country and the dividends are effectively connected with the permanent establishment.

Article 13. Interest

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

The proposed treaty generally limits the withholding tax in the source country on interest derived by a resident of one country from sources within the other country to 17.5 percent of the gross amount of interest paid. However, the withholding tax which the source country may impose is limited to 10 percent in the case of interest on a loan granted by a bank, savings institution, insurance company, or the like.

The reduced rates of withholding tax on interest will apply unless the recipient has a permanent establishment in the source country and the interest is effectively connected with the permanent establishment. If the interest is effectively connected with a permanent establishment then it will be taxed under the business profit provisions (Article 8) of the proposed treaty. This treaty generally conforms to that provided by other recent U.S. tax treaties, the U.S. model and OECD model tax treaty. The 17.5-percent rate is, however, among the highest allowed under U.S. treaties.

Interest paid by a resident of one country to a person other than a resident of the other country (and, in the case of interest paid by a resident of Israel, to a person other than a U.S. citizen) will be exempt from tax by the other country. However, this rule is inapplicable (1) if the interest is treated as income from sources within the other country under the proposed treaty's source of income rules or (2) if the recipient of the interest has a permanent establishment in the other country and the interest is effectively connected with the permanent establishment.

The proposed treaty also provides that interest derived beneficially by either country or by a tax-exempt instrumentality of either country will be exempt from tax by the other country. Under this rule income derived by the Export-Import Bank of the United States and the Overseas Private Investment Corporation (OPIC) on loans made to Israeli residents will be exempt from tax by Israel. This exemption also applies where a resident of one country receives interest income on debt obligations guaranteed or insured by that country or an instrumentality of that country.

The proposed treaty defines interest as income from money lent. In situations where the payor and recipient are related, the interest provision of the proposed treaty only applies to the amount of interest which would have been paid had they not been related.

Article 14. Royalties

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

Under the proposed treaty, the withholding tax on royalties derived by a resident of one country from sources within the other country is limited to 10 percent in the case of a copyright or film royalty and 15 percent in the case of an industrial royalty.

Copyright or film royalties are defined in the proposed treaty as payments of any kind made as consideration for the use of, or the right to use, copyrights of literary, artistic, scientific works, including copyrights of motion picture films or of films or tapes used for radio or television broadcasting. Industrial royalties are defined as payments of any kind made as consideration for the use of, or the right to use, patents, designs, models, plans, secret processes or formulas, trademarks, or other like property or rights. Copyright or film royalties and industrial royalties include gains derived from the sale, exchange, or other disposition of such property or rights to the extent the amounts received are contingent on the productivity, use, or disposition of the property or rights. If the amounts realized are not contingent, the provisions of Article 15 (Capital gains) may apply.

The reduced withholding rates do not apply where the recipient has a permanent establishment in the source country and the royalties are effectively connected with the permanent establishment. If the royalty is effectively connected with a permanent establishment, then it will be taxed under the business profits provisions (Article 8).

As in the case of the interest provision, the royalty provision does not apply to that part of a royalty paid to a related person which is considered excessive.

Article 15. Capital Gains

Under the Code, capital gains derived from U.S. sources by foreign investors are generally exempt from U.S. tax. Special rules are provided under which a foreign person is taxed on his gain from the disposition of U.S. real property or a U.S. real property interest.

The proposed treaty generally provides that capital gains derived by a resident of one country will be exempt from tax by the source country. The exemption does not apply where an individual resident of one country is present in the source country for 183 days or more during the taxable year. In addition, this provision does not apply to gains which are subject to the provisions relating to business profits (Article 8), income from real property (Article 7), royalties (Article 14), or shipping and air transport (Article 9).

Gains which a resident of one country derives from the sale or exchange of ships or aircraft operated in international traffic will be exempt from tax by the other country.

The proposed treaty contains an additional exception to the capital gains exemption which is not in previous U.S. tax treaties. Under Israeli tax law, gains from the sale of stock in an Israeli corporation are subject to tax by Israel regardless of where the sale occurs. Under this exception, Israel may tax a U.S. resident on the gain derived from the sale, exchange, or other disposition of stock in an Israeli corporation if (1) the U.S. resident actually or constructively owns, within the 12-month period preceding the transaction, stock representing more than 50 percent of the fair market value of the Israeli corporation's gross assets used in its trade or business are physically located in Israel on the last day of each of the 3 preceding taxable years.

Article 15A. Charitable Contributions

The proposed protocol would add a new Article 15-A to the proposed treaty which would provide that a citizen or a resident of the United States may treat as a charitable contribution certain amounts contributed to certain organizations organized under the laws of Israel. In order to qualify, the organization must be a charitable organization for purposes of the Israeli income tax laws and the contribution must be one which would have been treated as a charitable contribution had the organization been created or organized under the laws of the United States. The amount of any contribution which may be treated as a charitable contribution for any taxable year is limited to 25 percent of the donor's taxable income for the year (in the case of a corporation) or of the donor's adjusted gross income for the year (in the case of an individual) from Israeli sources. The general limitations of U.S. law on amounts which may be deducted are then to apply. A reciprocal provision is provided for residents of Israel donating to U.S. organizations. In general, under U.S. law, contributions to foreign organizations are not deductible as charitable contributions.

The provision contemplates that a determination will be made that an organization is or is not charitable. A note exchanged at the signing of the proposed protocol states that the competent authorities will review the procedures of the other country for deciding whether an organization is charitable to determine whether they are similar to their own procedures. If they are, then the competent authority will accept the certification of an organization by the other competent authority and not require an organization to qualify in both states. Under U.S. law, charities often have to file an application for exempt status and receive a ruling to the effect that they meet the requirements for exempt status (sec. 501(c)(3)). In the absence of this note, it is anticipated that an Israeli organization would have to go through that process in order to qualify as a charitable organization to which U.S. persons could donate.

Article 16. Independent Personal Services

Under the Code, the income of a nonresident alien from the performance of personal services in the United States is not taxed if the individual is not in the United States for at least 90 days, the compensation does not exceed $3,000, and the services are performed as an employee of a foreign person not engaged in a trade

or business in the United States or they are performed for a foreign permanent establishment of a U.S. person. His income is taxed at regular rates if the income is effectively connected with the conduct of a trade or business in the United States by the individual. (See discussion of U.S. taxation of business profits under Article 8. The performance of personal services within the United States can be a trade or business within the United States (sec. 864(b)).

The proposed treaty contains, in Articles 16, 17, and 18, provisions that limit the right of a country in which personal services are performed to tax the income from the performance of those services. Under the saving clause, the country of citizenship may tax the income in any event.

Under the proposed treaty, income from the performance of independent personal services (i.e., services performed as an independent contractor, not as an employee) in one country by a resident of the other country is exempt from tax in the country where the services are performed, unless the person performing the personal service is present in the source country for 183 or more days during the taxable year. This provision is modified in the case of income derived by public entertainers (theater, motion picture, radio and television artists, musicians, and athletes) by Article 18.

Article 17. Dependent Personal Services

Under the proposed treaty, as amended by the proposed protocol, income from services performed as an employee in one country (the source country) by a resident of the other country will not be taxable in the source country if four requirements are met: (1) the individual is present in the source country for less than 183 days during the taxable year; (2) the individual is an employee of a resident of, or a permanent establishment in, his country of residence; (3) the compensation is not borne by a permanent establishment of the employer in the source country; and (4) the income is subject to tax in the country of residence. Income of a U.S. citizen which is excluded from income under the section 911 exclusion for income earned abroad does not qualify for the exemption from Israel tax. This article is modified in certain cases by the specific articles dealing with government employees (Article 22), teachers (Article 23), and students and trainees (Article 24).

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

Article 18. Public Entertainers

This proposed treaty provides that, notwithstanding Articles 16 (Independent personal services) and 17 (Dependent personal services), income derived by an individual resident of one country from his performance of personal services in the other country as a public entertainer (such as a theater, motion picture, radio or television artist, a musician or an athlete) may be taxed by the other country, but only if the gross amount of such income exceeds $400 for each day the individual is present in the other country for the purpose of performing such services therein. If the entertainer re-

ceives a fixed amount for performing services on one day, the amount received will be prorated over the number of days on which individual performs the services.

Article 19. Amounts Received for Furnishing Personal Services of Others

The proposed treaty contains a provision which allows the country where personal services are performed to tax the income from the furnishing of the services under situations which have been viewed as an abuse of tax treaties. The purpose of this provision is to prevent individuals from using an entity of one country to furnish services performed in the other country and thereby avoid the payment of tax in either country.

Under the proposed treaty, as amended by the proposed protocol, amounts received by a resident of one country for furnishing services performed in the other country of one or more individuals, including public entertainers, may be taxed by the country where the services are performed if the resident directly or indirectly compensates the person or persons who actually performed the services. This provision is to apply if the person for whom the services were furnished either had the right (whether or not legally enforceable) to designate the person or persons who would render the services, or did in fact designate the person or persons, and the person performing the services is not a resident of either country who is subject to tax on the compensation. This provision is not to apply if it is established to the satisfaction of the competent authority of the source country that the organization furnishing the services was neither formed nor used in a manner which results in a substantial reduction on the income taxes from the furnishing of the services.

Article 20. Private Pensions and Annuities

Under the proposed treaty, private pensions and other similar remuneration, alimony, and annuities paid to a resident of one of the countries are taxable only in the country of residence. Child support payments paid by a resident of one country to a resident of the other are exempt in the recipient's country.

Article 21. Social Security Payments

Under the proposed treaty, social security and other public pension payments made by one country to residents of the other are to be exempt from tax in both countries. The saving clause does not apply to these payments. Accordingly, the exemption applies even to citizens of one of the countries. Under the provision relating to termination (Article 32(2)), this provision may be terminated by either country at any time after the proposed treaty enters into force.

Article 22. Governmental Functions

Under the proposed treaty, wages, including pensions or similar benefits, paid by one country to an individual for labor or personal services performed for that country in the discharge of governmental functions is exempt from tax by the other country. This ex-

emption does not apply if the individual performing the services is a citizen of, or acquires immigrant status in, the country where the services are performed. The exemption only applies to compensation for services performed for the national governments of the United States and Israel or their agencies.

Article 23. Teachers

The proposed treaty provides that a teacher or researcher who is a resident of one country will be exempt from tax in the other country on income from teaching or engaging in research in the host country if he is present in that country for a period not expected to exceed 2 years. The exemption only applies if the individual comes to the other country primarily for the purpose of teaching or engaging in research pursuant to an invitation of the host country or a recognized educational institution of the host country. It is not to apply with respect to income from research which is undertaken primarily for the benefit of a specific person or persons. If the teacher or researcher remains in the other country for a period exceeding 2 years, the exemption only applies to income earned during the 2-year period.

Article 24. Students and Trainees

Under the proposed treaty, residents of one country who become students in the other country will be exempt from tax in the host country on gifts from abroad used for maintenance or study and on any grant, allowance or award. In addition, a $3,000 annual exemption from tax by the host country is provided for personal service income (such as income from a part-time job) derived from sources within the country in which the individual is studying.

These exemptions and the visiting teachers' exemption (Article 23) may not be utilized for a period of more than 5 years. In addition, the benefits under the teachers' article are not available to an individual if, during the immediately preceding period, the individual received the benefit of the student provision.

In addition to the exemption regarding students, the proposed treaty follows the approach of other recent U.S. tax treaties and provides a limited exemption for personal services income of residents of one country who are employees of a resident of that country and who are temporarily present in the other country to study at an educational institution or to acquire technical professional, or business experience. This exemption is available for a period of 12 consecutive months and is limited to $7,500. The proposed treaty also provides an exemption for income from personal services performed in connection with training, research, or study by residents of one country who are temporarily present in the other country as participants in Government-sponsored training programs. This exemption is limited to $10,000.

If an individual qualifies for the benefits of more than one of the provisions of this Article and Article 23 (the visiting teachers' exemption), the individual may choose the most favorable provision but may not claim the benefits of more than one provision in any taxable year. This provision does not apply to students or trainees

who are citizens of, or who have acquired immigrant status in, the host country.

Article 25. Investment or Holding Companies

The proposed treaty contains a provision which denies the benefits of the dividends, interest, royalties, and capital gains articles to a corporation which is entitled in its country of residence to special tax benefits resulting in a substantially lower tax on those types of income than the tax generally imposed on corporate profits by that country. This provision only applies if more than 25 percent of the capital of the corporation is owned by nonresidents of that country. Similar, but in some cases broader, provisions are contained in several recent U.S. tax treaties and the U.S. model.

The purpose of this provision is to prevent a situation known as treaty shopping in which residents of third countries use a corporation in one treaty country, which is preferentially taxed in that country, to obtain the tax benefits which the proposed treaty provides for dividends, interest, royalties, and capital gains derived from the other country. This accords with the purpose of an income tax treaty between two countries to lessen or eliminate the amount of double taxation of income derived from sources within one country by a resident of the other country.

At the present time, neither Israel nor the United States grants to investment or holding companies the type of tax benefits with respect to dividends, interest, royalties and capital gains which would make this provision of the proposed treaty applicable. Thus, the provision will have effect only if Israel or the United States should subsequently enact special tax measures granting preferential tax treatment to dividends, interest, royalties, and capital gains received by an investment or holding company.

Article 26. Relief From Double Taxation

Background

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. The United States seeks to mitigate double taxation unilaterally by allowing U.S. taxpayers to credit the foreign income taxes that they pay 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 U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that insures that the foreign tax credit only offset U.S. tax on foreign source income. This limitation is computed on a worldwide consolidated basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income. Separate limitations on the foreign tax credit are provided for certain interest, DISC dividends, and oil income. A U.S. corporation that owns 10 percent or more of the stock of a foreign corporation may credit foreign taxes paid or deemed paid by that foreign corporation on earnings that are received as dividends (deemed paid credit). These deemed paid taxes are included in the U.S. shareholder's total foreign taxes paid for the

year the dividend is received and go into the general pool of taxes to be credited.

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 to 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 was dealt with in previous articles that limited the right of a source country to tax income, and that coordinated the source rules. This article provides further relief where both Israel and the United States will still tax the same item of income.

The present treaty provides for relief from double taxation by each country permitting a credit against its tax for the appropriate amount of taxes paid to the other country on income from sources within that other country. The credit is provided, however, only to the extent permitted under domestic law. The proposed treaty provides separate rules of relief of double taxation by the United States and Israel.

Proposed treaty

Under the proposed treaty, each country agrees to provide its citizens and residents with a foreign tax credit for the appropriate amount of income taxes paid to the other country. The credit allowed for U.S. tax purposes under this provision is subject to the provisions, including the limitations of sections 904 and 907, of U.S. law applicable to the year in question. The credit allowed by Israel is limited to the amount of Israeli tax attributable to income from sources within the United States.

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

For the purpose of applying the U.S. foreign tax credit under the treaty in relation to taxes paid to Israel, the rules set forth under Article 4 will be applied to determine the source of income. The Israeli taxes which the proposed treaty provides are creditable for U.S. tax purposes are the Israeli income tax (including capital gains tax), the company tax, the tax on gains from the sale of land under the land appreciation tax law, the tax on income levied under the services tax law (banking institutions and insurance companies), and certain compulsory war loans and security loans. With the exception of the compulsory loans, these taxes would probably be creditable for U.S. tax purposes in the absence of the

proposed treaty. The compulsory loans are not creditable income taxes for U.S. foreign tax credit purposes.

In addition to providing that the compulsory loans are to be creditable, the proposed treaty also sets forth special rules governing the manner in which the loans, any interest received, and repayments of the loans are to be treated for U.S. foreign tax credit purposes. First, the proposed treaty provides that if a U.S. citizen or resident claims a foreign tax credit (including a deemed-paid credit claimed by a U.S. corporation which is a 10-percent shareholder of Israeli corporation making the compulsory loan) for a compulsory loan to Israel, then any interest received on the loan is not to be treated as taxable income. Ordinarily, interest, including any interest received on refunds of foreign taxes, is treated as taxable income for U.S. tax purposes.

Second, it provides the repayment of the principal of the loan by Israel will be treated as a refund of Israeli tax for the year in which the loan was originally made. This rule is consistent with the treatment of the compulsory loans as creditable taxes. Further, as amended by the proposed protocol, the amount of the credit taken for the loan shall be recomputed even if the statute of limitations has run.

Third, there is a special rule which provides that, if the dollar value of the repayment exceeds the dollar value of the original loan (because of a decrease in the value of the Israeli pound versus the dollar or because of an inflation adjustment provided in connection with the loans), the excess in dollar value received is to be treated as taxable income for the year of the repayment. In the absence of this special rule, the excess dollar value received (at least to the extent of any exchange rate gains) would be treated as a refund of tax.

Fourth, the amount of interest which the United States may charge on any redetermination of U.S. tax for the year the loan was made which results from the loan repayment is limited by the proposed treaty to the amount of interest paid by Israel on the loan. This rule is consistent with the rules contained in the Code (sec. 905(c)) with respect to interest on such redeterminations. Finally, it provides that any such interest paid by the U.S. taxpayers as the result of the redetermination of the prior year's tax liability is not to be allowed as a tax deduction. Ordinarily, interest paid with respect to a redetermination of a prior year's U.S. tax liability is deductible by the taxpayer.

Article 27. Nondiscrimination

The proposed treaty contains a comprehensive nondiscrimination provision relating to taxes imposed at the national level similar to provisions which have been embodied in other recent U.S. income tax treaties. One country cannot discriminate by imposing more burdensome taxes on its residents who are citizens of the other country, or on permanent establishments of residents of the other country, than it imposes on comparable taxpayers. This provision does not, however, require either country to grant to residents of the other country the personal allowances, reliefs, or deductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents. The nondiscrimination

provision also applies to corporations of one country which are owned by residents of the other country.

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

Article 28. Mutual Agreement Procedure

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

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

A second provision directs the competent authorities to resolve any difficulties or doubts arising as to the application of the convention. Specifically, they are authorized to agree as to the attribution of profits to a resident of one country and its permanent establishment in another country, the allocation of income deductions or credits and the readjustment of taxes, the determination as to source of income, the characterization of items of income, and the mode of application of the charitable contributions (Article 15-A) and the exchange of information (Article 29) provisions.

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

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

Article 29. Exchange of Information

This article forms the basis for cooperation between the two states to attempt to deal with avoidance or evasion of their respec-

tive taxes and to enable them to obtain information so that they can properly administer the convention. The proposed treaty provides for the exchange of information which is necessary to carry out the provisions of the proposed treaty or for the prevention of fraud or for the administration of statutory provisions concerning taxes to which the convention applies. The exchange is limited, however, to information that could be obtained under the laws and administrative practices of each of the countries with respect to its own taxes. The information exchanged may relate to tax compliance generally and not merely to avoidance or evasion of tax.

Information exchanged is to be treated as secret except that it may be disclosed to any person concerned with or made a part of a public record with respect to the assessment or collection, or litigation concerning, the taxes to which the treaty applies. The Committee understands that there is a question as to whether, under the language of the treaty, the Congress, in the exercise of its oversight responsibilities, could obtain the information exchanged under this treaty. The Committee believes that such access is permitted, and is recommending that the treaty be approved subject to an understanding that such access is permitted.

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

Article 30. Diplomatic and Consular Officials

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

Article 31. Entry into Force

The proposed treaty will enter into force 30 days following the exchange of the instruments of ratification. It will become effective with respect to withholding tax rates on the first day of the second month following the date on which the proposed treaty enters into force. With respect to all other taxes, it will become effective for taxable years beginning on or after January 1st of the year following the date on which the proposed treaty comes into force.

The proposed protocol will also enter into force 30 days after the exchange of instruments of ratification. It will become effective in accordance with Article 31 of the proposed treaty.

Article 32. Termination

The proposed treaty will continue in force indefinitely, but either country may terminate it at any time after 5 years from its entry into force by giving at least 6 months' prior notice through diplomatic channels. If terminated, the termination will be effective with respect to income of taxable years beginning (or, in the case of withholding taxes, payments made) on or after April 1 next following the expiration of the 6-month period. The provisions of Article 21 (social security payments) may be terminated by either coun-

try at any time after the proposed treaty enters into force by prior notice given through diplomatic channels.

Exchange of Notes

Three notes were exchanged at the signing of the proposed protocol to the proposed treaty.

The first note deals with investment incentives through the tax treaty mechanism. The note states that during the negotiation of the treaty the Israeli delegation emphasized the need for including in any treaty provisions to encourage or promote investment in Israel. Specifically mentioned was an investment tax credit for that investment. The note states that the United States could not accept such provisions at the time of negotiation, but that it would reopen discussions on this issue if circumstances changed.

The second note concerns the administration of the provisions of Article 15-A (Charitable Contributions) which permits a resident of one country to deduct as charitable contributions, contributions to certain organizations created or organized in the other country. The effect of this note is discussed under Article 15-A.

The third note deals with the exchange of information provisions under the treaty (Article 29). The note recognizes that due to lack of technical capability and a manpower shortage, Israel cannot exchange information on a routine basis with respect to payments from Israel of dividends, interest, and royalties to residents of the United States and cannot acquire information which the Finance Ministry does not have at this time. The note commits Israel to supply the information as soon as it has remedied these deficiencies.

In general, the United States receives on a routine basis information from its treaty partners containing the names of U.S. persons who receive dividends, interest, royalties, and other income from that other country. If properly used, this information would assist the Internal Revenue Service in determining whether or not such income is being reported by the recipient. Information on specific request will be provided in any event.

○

73-305 (64)