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

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

ON OCTOBER 27, 1993

PREPARED BY THE STAFF

OF THE

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides an explanation of the proposed income tax treaty between the United States and the Czech Republic. The proposed treaty was signed on September 16, 1993. The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed treaty on October 27, 1993.

No income tax treaty between the United States and the Czech Republic is in force at present.

The proposed treaty is similar to other recent U.S. income tax treaties, the 1981 proposed U.S. model income tax treaty (the "U.S. model"), and the model income tax treaty of the Organization for Economic Cooperation and Development (the "OECD model"). However, the proposed treaty contains certain deviations from those documents.

Part I of the pamphlet summarizes the principal provisions of the proposed treaty. Part II presents a discussion of issues that the proposed treaty presents. Part III provides an overview of U.S. tax laws relating to international trade and investment and U.S. tax treaties in general. This is followed in Part IV by a detailed, article-by-article explanation of the proposed treaty.[2]

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and the Czech Republic* (JCS-18-93), October 26, 1993.

[2] For a copy of the proposed treaty, see Senate Treaty Doc. 103-17, October 21, 1993.

I. SUMMARY

In general

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

As in other U.S. tax treaties, these objectives would be achieved principally by each country agreeing to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other country. For example, the proposed treaty provides that a treaty country would not tax business income derived from sources within that country by residents of the other country unless the business activities in the first country are substantial enough to constitute a permanent establishment or fixed base (Articles 7 and 14). Similarly, the proposed treaty contains "commercial visitor" exemptions under which residents of one country performing personal services in the other country would not be required to pay tax in that other country unless their contact with that country exceeds specified minimums (Articles 14, 15, and 18). The proposed treaty provides that dividends, royalties, and certain gains derived by a resident of either country from sources within the other country generally would be taxable by both countries (Articles 10, 12 and 13). Generally, however, dividends and royalties received by a resident of one country from sources within the other country would be taxed by the source country on a restricted basis (Articles 10 and 12). The proposed treaty provides that as a general rule, the source country could not tax interest received by a resident of the other treaty country (Article 11).

In situations where the country of source would retain the right under the proposed treaty to tax income derived by residents of the other country, the treaty generally would provide for the relief of the potential double taxation generally by requiring the other country to grant a credit against its tax for the taxes paid to the source country.

The proposed treaty contains a "saving clause" similar to that contained in other U.S. tax treaties (Article 1(3)). Under this provision, the United States generally would retain the right to tax its citizens and residents as if the treaty had not come into effect. In addition, the proposed treaty contains the standard provision that it would not apply to deny a taxpayer any benefits that person is entitled to under the domestic law of the country or under any

other agreement between the two countries (Article 1(2)); that is, the treaty would only apply to the benefit of taxpayers.

The proposed treaty also contains a non-discrimination provision (Article 25) and provides for administrative cooperation and exchange of information between the tax authorities of the two countries to avoid double taxation and to prevent fiscal evasion with respect to income taxes (Articles 26 and 27).

Differences between proposed treaty and other treaties

The proposed treaty differs in certain respects from other U.S. income tax treaties, and from the U.S. model and OECD model treaties. Some of these differences are as follows:

(1) The U.S. excise tax imposed on insurance premiums paid to foreign insurers would not be a covered tax under the proposed treaty; that is, the proposed treaty would not preclude the imposition of the tax on insurance premiums paid to Czech insurers. This is a departure from the U.S. model treaty, but one that is shared by many U.S. treaties, including recent ones.

(2) The definition of the term "United States" as contained in the proposed treaty generally conforms to the definition provided in the U.S. model. In both treaties the term generally is limited to the United States of America, thus excluding from the definition U.S. possessions and territories. The proposed treaty, however, makes it clear that the United States would include its territorial sea and the seabed and subsoil of the adjacent area over which the United states may exercise rights in accordance with international law and in which laws relating to U.S. tax are in force. The U.S. model is silent with respect to this point.

(3) The proposed treaty does not contain a definition of the term "Czech Republic." In most U.S. treaties, the geographic area of both treaty countries is defined specifically.

(4) A U.S. citizen who is not also a U.S. resident (i.e., he or she does not have a substantial presence, permanent home, or habitual abode in the United States) generally would not be covered by the proposed treaty.[3] The U.S. model does cover such U.S. citizens. The United States rarely has been able to negotiate coverage for nonresident citizens, however.

(5) For purposes of qualifying for benefits under the proposed treaty, the term "resident of a Contracting State" would specifically include the governments of the two treaty countries, including their political subdivisions and local authorities, and any agencies or instrumentalities of those national or subnational governmental bodies. The term also would cover a pension trust or other organization that is constituted and operated exclusively to provide pension benefits or for religious, charitable, scientific, artistic, cultural, or other educational purposes and that is a resident of a treaty country under its domestic laws.

(6) The definition of permanent establishment in the proposed treaty in one facet is somewhat broader than that in the U.S. model, the OECD model, and in existing U.S. treaties. Under the proposed treaty, a permanent establishment would arise with re-

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[3] Similarly, the treaty would not cover an alien who has been admitted for permanent U.S. residence (i.e., a "green card" holder) unless that person has a U.S. substantial presence, permanent home, or habitual abode.

spect to the furnishing of services (including consultancy services) in one treaty country by an enterprise of the other country through employees or other personnel if activities of that nature continue (either for the same or a connected project) within the treaty country for a period or periods aggregating more than 9 months in any 12-month period. A permanent establishment would not exist, however, in any taxable year in which the activity (i.e., the furnishing of services) continues for a period or periods aggregating less than 30 days in that year.

(7) The proposed treaty provides clarification in a number of instances with respect to the ability of a country to tax profits derived by a business enterprise or derived from the performance of independent personal services. Specifically, the proposed treaty states that such profits may, in certain cases, be taxed by a country in which an enterprise carries on *or has carried on* business or where a person performs *or has performed* services. This clarifies that Code section 864(c)(6) would not be overridden by the proposed treaty.

(8) Unlike either the U.S. or OECD model treaties, the proposed treaty explicitly provides that nothing in Article 7 (Business Profits) would affect the application of any internal law of a treaty country relating to the determination of the tax liability of a person in cases where the information available to the competent authority of that country is inadequate to determine the profits to be attributed to a permanent establishment. This rule would apply only if, on the basis of the available information, the determination of the profits of the permanent establishment is consistent with the principles underlying Article 7.

(9) Both the proposed treaty and the U.S. model treaty contain definitions of the term "business profits." Under the U.S. model definition (as well as under the definition contained in many other U.S. income tax treaties), business profits include income from rental of tangible personal property. Thus, such rental income earned by a resident of one treaty country from sources in the other country would only be taxable in the source country if the income is attributable to a permanent establishment or fixed base of that taxpayer in that country. The proposed treaty, by contrast, would treat payments for the use of, or the right to use, industrial, commercial, or scientific equipment as royalties. These payments generally would be subject to a 10-percent source country withholding tax imposed on a gross income basis in the absence of the required nexus to a source country permanent establishment.

(10) As is true of some other existing U.S. income tax treaties, the proposed treaty would not provide protection from source country taxation of income from bareboat (i.e., without crew) leases of ships and aircraft in international traffic to the same extent as the U.S. model treaty, which exempts such income from source country tax as income from the operation of ships or aircraft in international traffic. For example, the model provides for exemption from tax in the source country for a bareboat lessor (such as a financial institution or a leasing company) that does not operate ships or aircraft in international traffic, but that leases ships or aircraft to others for use in international traffic. Under the proposed treaty, the exemption for shipping profits would not apply to

profits from the rental on a bareboat basis of ships or aircraft unless those rental activities are incidental to international shipping activities of the lessor.

(11) Similar to the OECD model treaty, the article on associated enterprises (Article 9) of the proposed treaty omits the provision found in the U.S. model treaty and in most other U.S. treaties which clarifies that neither treaty country is precluded from (or limited in) the use of any domestic law which permits the distribution, apportionment, or allocation of income, deductions, credits, or allowances between persons, whether or not residents of one of the treaty countries, owned or controlled directly or indirectly by the same interests, where necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such persons. It is understood, however, that the United States would be entitled under the proposed treaty to utilize the rules of Code section 482 in cases where it is necessary to reallocate profits among related enterprises to reflect results which would prevail in a transaction between independent enterprises.

(12) The proposed treaty, as well as both the U.S. and OECD models, provide for a correlative adjustment to be made by the competent authority of a treaty country to the income of a taxpayer in response to an adjustment made to that taxpayer's income by the other treaty country pursuant to its authority under the provisions of Article 9 (Associated Enterprises). The proposed treaty, unlike the models, specifies that no correlative adjustment would be required in the case of fraud, gross negligence, or willful default.

(13) Under the proposed treaty, as under the U.S. model treaty, direct investment dividends (i.e., dividends paid to companies resident in the other country that own directly at least 10 percent of the voting shares of the payor) generally will be taxable by the source country at a rate no greater than 5 percent. Other dividends generally will be taxable by the source country at a rate no greater than 15 percent. However like recent U.S. treaties, the proposed treaty would apply a withholding tax rate of 15 percent on dividends if those dividends are paid by a U.S. regulated investment company (RIC) regardless of whether the RIC dividends are paid to a direct or portfolio investor. The proposed treaty would not provide for a reduction of U.S. withholding tax on dividends paid by a real estate investment trust (REIT), unless the dividend is beneficially owned by an individual Czech resident holding a less than 10-percent interest in the REIT.

(14) Generally, the proposed treaty, the U.S. model, and the OECD model all share a common definition of the term "dividends."[4] The proposed treaty further defines this term, however, to include income from arrangements, including debt obligations, carrying the right to participate in profits, to the extent so characterized under the local law on the treaty country in which the income arises. That is, each country would apply its domestic law, for example, in differentiating dividends from interest.

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[4] That definition is income from shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the treaty country of which the company making the distribution is a resident.

(15) The proposed treaty, similar to U.S. treaties negotiated since 1986, would expressly permit imposition of the U.S. branch profits tax in certain cases. The rate of that tax could not exceed 5 percent.

The United States would be allowed under the proposed treaty to impose the branch profits tax on a Czech corporation that either has a permanent establishment in the United States, or is subject to tax on a net basis in the United States on income from real property or gains from the disposition of interests in real property. In cases where a Czech corporation conducts a trade or business in the United States but *not* through a permanent establishment, the proposed treaty would completely eliminate the branch profits tax that the Code would otherwise impose on such corporation (unless the corporation earned income from real property as described above).

According to the Treasury Department's technical explanation of the proposed treaty (hereinafter referred to as the "Technical Explanation"), it is understood that the U.S. branch profits tax imposed under the proposed treaty on a Czech company would be based on the company's dividend equivalent amount (as that term is defined under U.S. internal law). Moreover, the proposed treaty makes clear that nothing in the non-discrimination article (Article 25) should be construed as preventing either country from imposing its branch profits tax.

(16) Under the proposed treaty, like the U.S. model treaty, interest generally is exempt from source-country taxation. However, no exemption or reduction of U.S. withholding tax would be granted under the proposed treaty to a Czech resident that is a holder of a residual interest in a U.S. real estate mortgage investment conduit (REMIC) with respect to any excess inclusion.

(17) The proposed treaty generally exempts from source-country taxation royalties for the use of a copyright of literary, artistic, or scientific work, including films, tapes, and other means of image or sound reproduction. However, the proposed treaty would allow source-country taxation of certain other types of royalties at a maximum rate of 10 percent. Both the U.S. and OECD models exempt royalties from source-country tax. The category of royalties which would be subject to source country tax includes payments of any kind received as a consideration for the use of, or the right to use any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for industrial, commercial, or scientific equipment, or for information concerning industrial, commercial, or scientific experience.

(18) Although not found in the OECD model, the U.S. model, or many other U.S. treaties, the proposed treaty contains a special provision for determining the source of royalties. The staff understands that this provision only would apply for purposes of determining whether royalties are taxable in the source country; it would not be applicable in determining the source of royalties for purposes of computing the foreign tax credit under the article on relief from double taxation (Article 24). The special sourcing provision includes three separate rules. First, if the royalty is paid by a person, whether or not a resident of the United States or the Czech Republic, that has a permanent establishment or fixed base

in one of the countries in connection with which the liability to pay the royalty arose, and if the royalty is actually borne (i.e., is deducted in computing taxable income) by that permanent establishment or fixed base, then the royalty would be deemed to arise in the country in which the permanent establishment or fixed base is located. Second, if the royalty is not borne by a permanent establishment or fixed base located in one of the countries, then it would be treated as arising in the country of the payor's residence (as determined under the proposed treaty). Third, where the person paying a royalty neither is a resident of, nor has a permanent establishment or fixed base in, one of the treaty countries, but the royalty relates to the use of (or right to use) property in one of the countries, then the royalty would be treated as arising in the country where such property is used. Similar source rules for royalties are contained in the U.S. treaties with Australia, New Zealand and Spain.

By contrast, since the U.S. model does not specifically provide (for any purpose) a sourcing rule for royalties, the applicable rule of domestic law applies. With respect to the domestic law of the United States, royalties generally are sourced in the country where the property giving rise to the royalty is used (Code sec. 861(a)(4)).

(19) In a manner similar to the U.S. model treaty, the proposed treaty provides that income derived by an individual who is a resident of one of the treaty countries from the performance of personal services in an independent capacity generally would not be taxable in the other treaty country unless the person has a fixed base in the other country which he or she regularly makes use of in performing his or her activities; in such a case, the other country would be permitted to tax the income from services performed in that country which is attributable to the fixed base. Contrary to the U.S. model, however, the proposed treaty also would allow a treaty country to tax income attributable to independent personal services performed within its territory by a resident of the other country if the individual is present in the source country for a period or periods exceeding a total of 183 days in any 12-month period.

(20) The dependent personal services article of the proposed treaty varies slightly from that article of the U.S. model. Under the U.S. model, salaries, wages, and other similar remuneration derived by a resident of one treaty country in respect of employment exercised in the other country is taxable only in the residence country (i.e., is not taxable in the other country) if the recipient is present in the other country for a period or periods not exceeding in the aggregate 183 days in the taxable year concerned and certain other conditions are satisfied. The proposed treaty contains a similar rule, but provides that the measurement period for the 183-day test would not be limited to the taxable year; rather, the source country could not tax the income if the individual is not present there for a period or periods exceeding in the aggregate 183 days in a 12-month period.

(21) The proposed treaty would allow directors' fees derived by a resident of one treaty country for services performed in the other country in his or her capacity as a member of the board of directors (or another similar organ) of a company which is a resident of the

other country to be taxed in that other country. The U.S. model treaty, on the other hand, generally treats directors' fees under other applicable articles, such as those on personal service income. Under the U.S. model (and the proposed treaty), the country where the recipient resides generally has primary taxing jurisdiction over personal service income.

(22) The proposed treaty contains a limitation on benefits, or "anti-treaty shopping," article similar to the limitation on benefits articles contained in recent U.S. income tax treaties and protocols and in the branch tax provisions of the Internal Revenue Code.

(23) Like the U.S. model treaty, the proposed treaty would allow a source country to tax income derived by artistes and sportsmen from their activities as such, without regard to the existence of a fixed base or other contacts with the source country, if that income exceeds $20,000 in a taxable year. U.S. income tax treaties generally follow the U.S. model rule, but often use a lower annual income threshold. Under the OECD model, entertainers and athletes may be taxed by the country of source, regardless of the amount of income that they earn from artistic or athletic endeavors.

The proposed treaty includes an exception from source country taxation of artistes and sportsmen resident in the other country if the visit to the source country is substantially supported by public funds of the country of residence or is made pursuant to a specific arrangement agreed to by the Governments of the two countries. Neither the U.S. model nor the OECD model contains such an exception.

(24) The U.S. model treaty provides that pensions (other than those relating to government service) and other similar remuneration derived and beneficially owned by a resident of a treaty country in consideration of past employment are taxable only in the residence country. The proposed treaty contains a similar provision, but would extend coverage explicitly to pensions and other similar remuneration in consideration of past employment by another individual resident of the same country as the person deriving and beneficially owning the income. Thus, for example, the proposed treaty makes clear that it would cover pension payments received by a person related to past employment of that person's spouse.

(25) The U.S. model, the OECD model, and the proposed treaty all provide a general exemption from host-country taxation of certain payments from abroad received by students and trainees who are or were resident in one country and studying or training in the host country. Whereas the U.S. and OECD models permit this exemption without regard to any income threshold or time limit, the proposed treaty, in certain cases, would allow it only for certain limited time periods, and in other cases, subject to maximum income thresholds. Unlike the models, the proposed treaty would also exempt anywhere from $5,000 to $10,000 per year (depending on the circumstances) of personal services income of persons who qualify for benefits under this article (Article 21) of the proposed treaty.

The proposed treaty would extend benefits under this article to certain teachers and researchers.

(26) The relief from double taxation article of the proposed treaty contains a special rule for U.S. citizens who reside in the Czech Republic. In this case, the proposed treaty provides that items of in-

come which could be taxed by the United States solely by reason of citizenship (under the saving clause) would be treated as Czech source income to the extent necessary to avoid double taxation. In no event, however, would the tax paid to the United States be less than the tax that would be paid if the individual were not a U.S. citizen.

(27) Under the proposed treaty's mutual agreement procedure rules, a case must be presented for consideration to a competent authority within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the proposed treaty. The U.S. model does not specify any time limit for presentation of a case to a competent authority, whereas the OECD model provides an identical three-year time limit for this purpose.

(28) The U.S. model provides rules regarding tax collection assistance to be provided to one treaty country by the other treaty country. Specifically, the U.S. model provision states that each treaty country shall endeavor to collect on behalf of the other treaty country such amounts as may be necessary to ensure that treaty relief granted from taxation generally imposed by that other country does not inure to the benefit of persons not entitled thereto. Neither the proposed treaty nor the OECD model contain similar clauses.

(29) With respect to taxes other than withholding taxes, the proposed treaty would be effective for taxable periods beginning on or after the first day of January of the year in which it enters into force.[5] The U.S. model treaty, on the other hand, does not provide for retroactive application. Under the model, provisions relating to taxes other than withholding taxes would be effective for taxable periods beginning on or after the first day of January next following the date on which the treaty enters into force.

[5] The proposed treaty would enter into force upon the exchange of instruments of ratification between the United States and the Czech Republic.

II. ISSUES

The proposed treaty presents the following specific issues.

(1) Treaty shopping

The proposed treaty, like a number of U.S. income tax treaties, generally would limit 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 is intended to benefit residents of the Czech Republic and the United States only, residents of third countries sometimes attempt to use a treaty to obtain treaty benefits. This is known as treaty shopping. Investors from countries that do not have tax treaties with the United States, or from countries that have not agreed in their tax treaties with the United States to limit source-country taxation to the same extent that it is limited in another treaty may, for example, attempt to secure a lower rate of U.S. tax on interest by 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 of the proposed treaty is similar to an anti-treaty shopping provision in the Internal Revenue Code (as interpreted by Treasury regulations) and in several newer treaties, including the treaties that are the subject of this hearing. Some aspects of the provision, however, differ either from a corresponding 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. An issue, then, is whether the proposed anti-treaty shopping provisions would effectively forestall potential treaty shopping abuses.

One provision of the anti-treaty shopping article of the proposed treaty would be 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 company's country of residence, while the proposed treaty (like several newer treaties and an anti-treaty shopping provision in the Code) lowers the qualifying percentage to 50, and broadens the class of qualifying shareholders to include residents of either treaty country and certain other specified persons. Thus, this safe harbor would be considerably easier to enter under the proposed treaty. On the other hand, counting for this purpose shareholders who are residents of either treaty country would not appear to invite the type of abuse at which the provision is aimed; that is, ownership by third-country

residents attempting to obtain treaty benefits. In addition, a base erosion test contained in the proposed treaty would provide protection from certain potential abuses of a Czech conduit entity.

Another item contained in the proposed treaty's anti-treaty shopping rules differs from 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 treaty contains a more precise test that would allow denial of benefits only with respect to income not derived in connection with the active conduct of a trade or business carried on the persons country of residence. (However, this active trade or business test would not apply with respect to a business of making or managing investments, so benefits can be denied with respect to such a business regardless of how actively it is conducted.) In addition, the proposed treaty would give the competent authority of the source country the ability to override this standard. The Technical Explanation accompanying the treaty provides some elaboration as to how these rules would be applied.

The practical difference between the proposed treaty tests and the earlier tests depends upon how they would be interpreted and applied. The principal purpose test might be applied leniently (so that any colorable business purpose suffices to preserve treaty benefits), or it might be applied strictly (so that any significant intent to obtain treaty benefits suffices to deny them). Similarly, the standards in the proposed treaty 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., would 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 would have to adjust the operation of the proposed treaty, it should satisfy itself that its rules as applied would adequately deter treaty shopping abuses. Further, the proposed anti-treaty shopping provision might be effective in preventing third-country investors from obtaining treaty benefits by establishing investing entities in the Czech Republic; for example, those investors might be unwilling to share ownership of such investing entities on an equal basis with U.S. or Czech residents or other qualified owners in order to meet the ownership test. The base erosion test would provide protection from certain potential abuses of a Czech conduit. 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 would be an adequate tool for preventing possible future treaty-shopping abuses.

(2) Taxation of equipment rentals

It is generally the treaty policy of the United States to exempt from source country taxation any royalties arising in one treaty country and derived and beneficially owned by a resident of the other country. Moreover, the definition of "royalties" contained in the U.S. model treaty excludes payments for the use of, or right to use, industrial, commercial, or scientific equipment (e.g., rental income for the use of machinery). The practical effect of these rules is that, under the preferred U.S. treaty policy, the above-described items received by a resident of one treaty country are considered "business profits," and as such, may not be taxed by the other country unless the income is attributable to a permanent establishment or fixed base of that person in that other country.

By contrast, the proposed treaty would permit gross-basis source-country taxation of certain royalties, at a rate not to exceed 10 percent, if the payments are not attributable to a permanent establishment or fixed base situated in the source country.[6] Moreover, the proposed treaty would specifically include in the category of "royalties" that could be taxed by the source country payments for the use of (or right to use) industrial, commercial, or scientific equipment. In this regard, the proposed treaty would make it easier for the source country to impose tax on such income.

Although contrary to general policy, similar provisions have been included in a number of U.S. income tax treaties that are now in force. Many of these treaties are with so-called "developing countries." The issue is whether or not it would be appropriate in the context of the proposed treaty to permit the source country to impose a gross-basis tax on payments for the use (or right to use) such equipment in cases where the taxpayer does not maintain a permanent establishment or fixed base in that country.

(3) Associated enterprises and permanent establishments

The proposed treaty, like most other U.S. tax treaties, contains an arm's-length pricing and allocation provision. The proposed treaty would recognize the right of each country to reallocate profits among related enterprises residing in each country, if a reallocation would be necessary to reflect the conditions which would have been made between independent enterprises. In addition, the proposed treaty would require each country to attribute to a permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise. The Code, under section 482, provides the Secretary of the Treasury the power to make reallocations wherever necessary in order to prevent evasion of taxes or clearly to reflect the income of related enterprises. Under regulations, the Treasury Department implements this authority using an arm's-length standard, and has indicated its belief that the standard it applies is fully consistent with the proposed treaty. A significant function of this authority is to ensure that the United States asserts taxing jurisdiction over its fair share of the worldwide income of a multinational enterprise.

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[6] If the income is attributable to such a permanent establishment or fixed base, then the treatment of the income would be governed by the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as appropriate.

Some have argued in the recent past that the IRS has not performed adequately in this area. Some have argued that the IRS cannot be expected to do so using its current approach. They argue that the approach now set forth in the regulations is impracticable, and that the Treasury Department should adopt a different approach, under the authority of section 482, for measuring the U.S. share of multinational income.[7] Some prefer a so-called "formulary apportionment," which can take a variety of forms. The general thrust of formulary apportionment is to first measure total profit of a person or group of related persons without regard to geography, and only then to apportion the total, using a mathematical formula, among the tax jurisdictions that claim primary taxing rights over portions of the whole. Some prefer an approach that is based on the expectation that an investor generally will insist on a minimum return on investment or sales.[8]

A debate exists whether an alternative to the Treasury Department's current approach would violate the arm's-length standard embodied in Article 9 of the proposed treaty, or the non-discrimination rules embodied in Article 25.[9] Some, who advocate a change in internal U.S. tax policy in favor of an alternative method, fear that U.S. obligations under treaties such as the proposed treaty would be cited as obstacles to change. The issue is whether the United States should enter into agreements that might conflict with a move to an alternative approach in the future, and if not, the degree to which U.S. obligations under the proposed treaty would in fact conflict with such a move.

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[7] See generally *The Breakdown of IRS Tax Enforcement Regarding Multinational Corporations: Revenue Losses, Excessive Litigation, and Unfair Burdens for U.S. Producers: Hearing Before the Senate Committee on Governmental Affairs,* 103d Cong., 1st Sess. (1993) (hereinafter, *Hearing Before the Senate Committee on Governmental Affairs).*

[8] See *Tax Underpayments by U.S. Subsidiaries of Foreign Companies: Hearings Before the Subcommittee on Oversight of the House Committee on Ways and Means,* 101st Cong., 2d Sess. 360-61 (1990) (statement of James E. Wheeler); H.R. 460, 461, and 500, 103d Cong., 1st Sess. (1993); sec. 304 of H.R. 5270, 102d Cong., 2d Sess. (1992) (introduced bills); see also *Department of the Treasury's Report on Issues Related to the Compliance with U.S. Tax Laws by Foreign Firms Operating in the United States: Hearing Before the Subcommittee on Oversight of the House Committee on Ways and Means,* 102d Cong., 2d Sess. (1992).

[9] Compare *Hearing Before the Senate Committee on Governmental Affairs* at 26, 28. ("I do not believe that the apportionment method is barred by any tax treaty that United States has now entered into.") (statement of Louis M. Kauder) *with* a recent statement conveyed by foreign governments to the U.S. State Department that "[w]orldwide unitary taxation is contrary to the internationally agreed arm's length principle embodied in the bilateral tax treaties of the United States" (letter dated 14 October 1993 from Robin Renwick, U.K. Ambassador to the United States, to Warren Christopher, U.S. Secretary of State). See also *Foreign Income Tax Rationalization and Simplification Act of 1992: Hearings Before the House Committee on Ways and Means,* 102d Cong., 2d Sess. 224, 246 (1992) (written statement of Fred T. Goldberg, Jr., Assistant Secretary for Tax Policy, U.S. Treasury Department)

III. OVERVIEW OF UNITED STATES TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES

This overview contains two parts. The first part describes the U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. The second part discusses the objectives of U.S. tax treaties and describes some of the modifications they make in U.S. tax rules.

A. United States Tax Rules

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

Income of a nonresident alien individual or foreign corporation that is effectively connected with the conduct of a trade or business in the United States is subject to tax at the normal graduated rates on the basis of net taxable income. Deductions are allowed in computing effectively connected taxable income, but only if and to the extent that they are related to income that is effectively connected. A foreign corporation is also subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the U.S. effectively connected earnings of the corporation that are removed in any year from the conduct of its U.S. trade or business. A foreign corporation is also subject to a branch-level excess interest tax, which amounts to 30 percent of the interest deducted by the foreign corporation in computing its U.S. effectively connected income but not paid by the U.S. trade or business.

U.S. source fixed or determinable annual or periodical income of a nonresident alien individual or foreign corporation (generally including interest, dividends, rents, salaries, wages, premiums, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to tax at a rate of 30 percent of the gross amount paid. In the case of certain insurance premiums earned by such persons, the tax is 1 or 4 percent of the premium paid. These taxes generally are collected by means of withholding (hence these taxes are often called "withholding taxes").

Withholding taxes are often reduced or eliminated in the case of payments to residents of countries with which the United States has an income tax treaty. In addition, certain statutory exemptions from withholding taxes are provided. For example, interest on de-

posits with banks or savings institutions is exempt from tax unless the interest is effectively connected with the conduct of a U.S. trade or business carried on by the recipient. Exemptions are provided for certain original issue discount and for income of a foreign government or international organization from investments in U.S. securities. Additionally, certain interest paid on portfolio debt obligations is exempt from the 30-percent tax. Certain U.S. income tax treaties also provide for exemption from tax in certain cases.[10]

U.S. source noneffectively connected capital gains of nonresident alien individuals and foreign corporations are generally exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien individual who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the disposition of interests in U.S. real estate.

The source of income received by nonresident alien individuals and foreign corporations is determined under rules contained in the Code. Interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation generally are considered U.S. source income. Interest paid by the U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation. However, if during a three-year testing period a U.S. corporation or U.S. resident alien individual derives more than 80 percent of its gross income from the active conduct of a trade or business in a foreign country or possession of the United States, interest paid by that person will be foreign source rather than U.S. source. Moreover, even though dividends paid by a corporation meeting this test (an "80/20" company) are U.S. source, a fraction of each dividend corresponding to the foreign source fraction of the corporation's income for the three-year period is not subject to U.S. withholding tax. Conversely, dividends and interest paid by a foreign corporation generally are treated as foreign source income. However, in the case of a dividend paid by a foreign corporation, 25 percent or more of whose gross income over a three-year testing period consists of income that is treated as effectively connected with the conduct of a U.S. trade or business, a portion of such dividend will be considered U.S. source income. The U.S. source portion of such dividend generally is equal to the total amount of the dividend, multiplied by the ratio over the testing period of the foreign corporation's U.S. effectively connected gross income to total gross income. (No tax is imposed, however, on a foreign recipient of a dividend to the extent of such U.S. source portion unless a treaty prevents application of the branch profits tax on the paying corporation.)

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

Since the United States taxes U.S. persons on their worldwide income, double taxation of income can arise because income earned abroad by a U.S. person may be taxed by the country in which the

[10] Where the Code or treaties eliminate tax on interest paid by a corporation to certain related persons, the Code generally provides for denial of interest deductions at the corporate level to the extent that its net interest expenses exceed 50 percent of adjusted taxable income. The amount of the disallowance is limited however, by the amount of tax-exempt interest paid to related persons and the amount of interest paid on debt guaranteed by tax-exempt persons.

income is earned and also by the United States. The United States seeks to mitigate this double taxation generally by allowing U.S. persons to credit their foreign income taxes against the U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions of the Code contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign source income. The foreign tax credit limitation generally is computed on a worldwide consolidated (overall) basis. Pursuant to rules enacted as part of the Tax Reform Act of 1986 (the "1986 Act"), the overall limitation is computed separately for certain classifications of income (i.e., passive income, high withholding tax interest, financial services income, shipping income, dividends from each noncontrolled section 902 corporation, DISC dividends, FSC dividends, and taxable income of a FSC attributable to foreign trade income) in order to prevent the crediting of foreign taxes on certain types of traditionally high-taxed foreign source income against the residual U.S. tax on certain items of traditionally low-taxed foreign source income. Also, a special limitation applies to the credit for foreign taxes imposed on foreign oil and gas extraction income.

Prior to the Tax Reform Act of 1984 (the "1984 Act"), a U.S. person could convert U.S. source income to foreign source income, thereby circumventing the foreign tax credit limitation, by routing the income through a foreign corporation. The 1984 Act added to the foreign tax credit provisions special rules that prevent U.S. persons from converting U.S. source income into foreign source income through the use of an intermediate foreign payee. These rules apply to 50-percent U.S.-owned foreign corporations only. In order to prevent a similar technique from being used to average foreign taxes among the separate limitation categories, the 1986 Act provided look-through rules for the characterization of inclusions and income items received from a controlled foreign corporation.

Prior to the 1986 Act, a U.S. taxpayer with substantial economic income for a taxable year potentially could avoid all U.S. tax liability for such year so long as it had sufficient foreign tax credits and no domestic income (whether or not the taxpayer had economic income from domestic operations). In order to mandate at least a nominal tax contribution from all U.S. taxpayers with substantial economic income, the 1986 Act provided that foreign tax credits generally cannot exceed 90 percent of the pre-foreign tax credit tentative minimum tax (determined without regard to the net operating loss deduction).

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

B. United States Tax Treaties—In General

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

Notwithstanding the unilateral relief measures of the United States and its treaty partners, double taxation might arise because of differences in source rules between the United States and the other country. Likewise, if each country considers the same deduction allocable to income that it treats as foreign source income, double taxation can result. Problems sometimes arise in the determination of whether a foreign tax qualifies for the U.S. foreign tax credit. Also, double taxation may arise in situations were a corporation or individual may be treated as a resident of both countries and be taxed on a worldwide basis by both.

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

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

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

Treaties first seek to eliminate double taxation by defining the term "resident" so that an individual or corporation generally will not be subject to primary taxing jurisdiction as a resident by each

of the two countries. Treaties also provide that neither country will tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a branch or other permanent establishment or fixed base in that jurisdiction. The treaties contain commercial visitation exemptions under which individual residents of one country performing personal services in the other will not be required to pay tax in that other country unless their contacts exceed certain specified minimums, for example, presence for a set number of days or earnings of over a certain amount.

Treaties deal with passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country by either providing that they are taxed only in the country of residence or by providing that the source country's withholding tax generally imposed on those payments is reduced. As described above, the United States generally imposes a 30-percent withholding tax and agrees to reduce this tax (or in the case of some income, eliminate it entirely) in its tax treaties, in return for reciprocal treatment by its treaty partner.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect. Such a treaty provision generally is referred to as a so-called "saving clause." Double taxation also may arise, notwithstanding the existence of a treaty, because most countries will not exempt passive income from tax at the source.

Double taxation is further mitigated either by granting a credit for income taxes paid to the other country, or, in the case of some U.S. treaty partners, by providing that income is exempt from tax in the country of residence. The United States provides in its treaties that it will allow a credit against U.S. tax for income taxes paid to the treaty partners, subject to the various limitations of U.S. law.

The objective of preventing tax avoidance and evasion generally is accomplished in treaties by the agreement of each country to exchange tax-related information. The treaties generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out the provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information not obtainable under its laws or in the normal course of its administration, or to supply information that would disclose trade secrets or other information the disclosure of which would be contrary to public policy. The provisions generally result in an exchange of routine information, such as the names of U.S. residents receiving investment income. The Internal Revenue Service (and the treaty partner's tax authorities) also can request specific tax information from a treaty partner. This can include information to be used in a criminal investigation or prosecution.

Administrative cooperation between the countries is further enhanced under the treaties by the inclusion of a competent authority mechanism to resolve double taxation problems arising in individ-

ual cases and, more generally, to facilitate consultation between tax officials of the two governments.

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

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

IV. EXPLANATION OF PROPOSED TAX TREATY

A detailed, article-by-article explanation of the proposed income tax treaty between the United States and the Czech Republic appears below.

Article 1. General Scope

The general scope article describes the persons who may claim the benefits of the proposed treaty and contains other rules, including the "saving clause" that generally allows each country to tax its citizens and residents notwithstanding the proposed treaty.

The proposed treaty generally would apply to residents of the United States and to residents of the Czech Republic, with specific exceptions designated in other articles. This follows other U.S. income tax treaties, the U.S. model treaty, and the OECD model treaty. Residence is defined in Article 4.

The proposed treaty also contains the rule found in other U.S. tax treaties that its provisions would not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance otherwise accorded by the domestic laws of either treaty country or any other agreement between the two countries. Thus, the proposed treaty would apply only where it benefits taxpayers. In cases where a treaty provision would have a detrimental effect on a taxpayer, the taxpayer may elect to utilize the rules of domestic law or of another agreement between the two countries.

As set forth in the Technical Explanation, the fact that the proposed treaty would only apply to a taxpayer's benefit does not mean that a taxpayer could inconsistently select among treaty and internal law provisions in order to minimize its overall tax burden. The Technical Explanation sets forth the following example. Assume a resident of the Czech Republic has three separate businesses in the United States. One business is profitable, and constitutes a U.S. permanent establishment. The other two are trades or businesses that would earn effectively connected income as determined under the Internal Revenue Code, but do not constitute permanent establishments as determined under the proposed treaty; one trade or business is profitable and the other incurs a net loss. Under the Code, all three operations would be subject to U.S. income tax, in which case the losses from the unprofitable line of business could offset the taxable income from the other lines of business. On the other hand, only the income of the operation which gives rise to a permanent establishment would be taxable by the United States under the proposed treaty. The Technical Explanation makes clear that the taxpayer could not invoke the proposed treaty to exclude the profits of the profitable trade or business and invoke U.S. internal law to claim the loss of the unprofitable trade

or business against the taxable income of the permanent establishment.[11]

Like all U.S. income tax treaties, the proposed treaty contains a "saving clause." Under this clause, with specific exceptions described below, the proposed treaty would not restrict the taxation by either country of its residents or its citizens, including former citizens. By reason of this saving clause, unless otherwise specifically provided in the proposed treaty, the United States would continue to tax its citizens who are residents of the Czech Republic as if the treaty were not in force. The term "resident" for purposes of the treaty (and thus, for purposes of the saving clause) includes corporations and other entities as well as individuals (Article 4 (Resident)). Because Article 4 would generally provide for the determination of a single residence country for persons covered by the proposed treaty, the saving clause would have two effects. First, it would preserve the right of a country to tax its residents in situations where exclusive taxing jurisdiction would be granted (except for this clause) to the other country. Second, it would preserve the right of a country to tax its citizens in situations where the citizen would be treated as a resident of the other country pursuant to the proposed treaty, and exclusive taxing jurisdiction would be granted (except for this clause) to the country of residence. In cases where a country would apply the saving clause to tax its residents or citizens, the proposed treaty would provide a mechanism for eliminating resulting double taxation (Article 24).

Under Code Section 877, a former U.S. citizen whose loss of citizenship had as one of its principal purposes the avoidance of U.S. income, estate or gift taxes is, with respect to certain income, subject to U.S. tax for a period of 10 years following the loss of citizenship. The treaty language described above corresponds to provisions found in the U.S. model and most recent treaties which would grant a country the right to tax former citizens. Even absent a specific provision, the Internal Revenue Service has taken the position that the United States retains the right to tax former citizens resident in the other treaty country.[12]

The proposed treaty would provide exceptions to the saving clause for certain benefits conferred by the articles dealing with associated enterprises (Article 9), pensions, alimony, and child support (Article 19); relief from double taxation (Article 24); non-discrimination (Article 25); and mutual agreement procedures (Article 26). These exceptions are consistent with those in the U.S. model.

In addition, the saving clause would not apply to the benefits conferred by one of the countries under the articles dealing with government service (Article 20), students, trainees, teachers, and researchers (Article 21), and diplomatic agents and consular officers (Article 28), with respect to individuals who are neither citizens of, nor lawful permanent residents in, the conferring country. This exclusion is standard, and is included in the U.S. model. With respect to the United States, an individual is considered a lawful permanent resident if he or she has been admitted to the United

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[11] See Rev. Rul. 84-17, 1984-1 C.B. 10.
[12] Rev. Rul. 79-152, 1979-1 C.B. 237.

States as a permanent resident under U.S. immigration laws (i.e., holds a "green card").

Article 2. Taxes Covered

In the case of the United States, the proposed treaty would apply to the Federal income taxes imposed by the Internal Revenue Code, excluding the accumulated earnings tax, the personal holding company tax, and social security taxes. Additionally, the proposed treaty would apply to the excise taxes imposed with respect to the investment income of private foundations.[13] In a departure from the U.S. model treaty and several other U.S. treaties, the excise tax imposed on insurance premiums paid to foreign insurers would not be a covered tax under the proposed treaty.

In the case of the Czech Republic, the proposed treaty would apply to the income taxes imposed by the income tax law and the tax on immovable property (real property tax).

The proposed treaty also contains a provision generally found in U.S. income tax treaties to the effect that it would apply to identical or substantially similar taxes that either country may subsequently impose in addition to, or in place of, the existing taxes. The proposed treaty, like the U.S. model, would obligate the competent authority of each treaty country to notify the competent authority of the other country of any significant changes in the tax laws of its country and of any published material concerning application of the treaty, including explanations, regulations, rulings, or judicial decisions.

Article 3. General Definitions

The proposed treaty contains certain of the standard definitions found in most U.S. income tax treaties.

The term "Contracting State" would mean the United States or the Czech Republic, as the context requires.

The term "United States" would mean the United States of America, but would not include Puerto Rico, the Virgin Islands, Guam or any other U.S. possession or territory. When the term is used in a geographical sense, it would include the territorial sea and the seabed and subsoil of the adjacent area over which the United States may exercise rights in accordance with international law and in which the laws relating to U.S. tax are in force. The intent of this rule is to cover the U.S. continental shelf in conformity with the definition of continental shelf contained in section 638 of the Code.

The proposed treaty does not provide a definition of the term "the Czech Republic."

The term "person" would be defined to include an individual, an estate, a trust, a partnership, a company, and any other body of persons. A "company" would be any body corporate or any entity which is treated as a body corporate for tax purposes.

An "enterprise of a Contracting State" and "enterprise of the other Contracting State" would be defined, respectively, as an enterprise carried on by a resident of one of the treaty countries and

[13] Code sec. 4948 imposes a 4-percent excise tax on the gross U.S. source investment income for the taxable year of every foreign organization which is a private foundation. (See, generally, Code secs. 4940–4948.)

an enterprise carried on by a resident of the other treaty country. Although the treaty does not define the term "enterprise," it would have the same meaning that it has in other U.S. tax treaties; that is, the trade or business activities undertaken by an individual, partnership, company, or other entity.

The proposed treaty defines "international traffic" as any transport by a ship or aircraft operated by a resident of one of the treaty countries, except where the transport is solely between places in the other country (i.e., wholly within the other country). Accordingly, with respect to a Czech enterprise, purely domestic transport in the United States would not be international traffic.

The U.S. competent authority would be the Secretary of Treasury or his delegate. The U.S. competent authority function has been delegated to the Commissioner of Internal Revenue, who has redelegated the authority to the Assistant Commissioner (International). On interpretive issues, the latter acts with the concurrence of the Associate Chief Counsel (International) of the IRS.

The Czech competent authority would be the Minister of Finance or his authorized representative.

Article 25 (Non-discrimination) of the proposed treaty defines the term "nationals" to mean individuals possessing the nationality of the relevant treaty country, and legal persons, partnerships, and associations deriving their status from the law in force in the United States or the Czech Republic. Under this definition, for example, a corporation organized under the law of one of the United States is a U.S. national. One result of this broad definition is a broad application of the proposed treaty's non-discrimination rules.

The proposed treaty also contains the standard provision that, unless the context otherwise requires or the competent authorities of the two countries establish a common meaning, all terms not otherwise defined by the proposed treaty would have the meaning which they have under the applicable tax laws of the country applying the proposed treaty.

Article 4. Resident

The assignment of a country of residence is important because the benefits of the proposed treaty generally would be available only to a "resident" of one of the countries as that term is defined in the treaty. Furthermore, double taxation would often be avoided by the proposed treaty assigning one of the countries as the country of residence where under the laws of the countries the person is a resident of both.

Under U.S. law, residence of an individual is important because a resident alien is taxed on his or her worldwide income, while a nonresident alien is taxed only on U.S. source income and on income that is effectively connected with a U.S. trade or business. Under the standards for determining residence provided in the Deficit Reduction Act of 1984 (the "1984 Act"), an individual who spends substantial time in the United States in any year or over a three-year period generally is a U.S. resident. A permanent resident for immigration purposes (i.e., a "green card" holder) also is a U.S. resident. The standards for determining residence provided in the 1984 Act do not alone determine the residence of a U.S. citizen for the purpose of any U.S. tax treaty (such as a treaty that

benefits residents, rather than citizens, of the United States). A company is domestic, and therefore taxable in the United States on its worldwide income, if it is organized in the United States or under the laws of the United States or a State or the District of Columbia.

The proposed treaty generally would define "resident of a Contracting State" to mean any person who, under the laws of that State, is liable to tax therein by reason of his or her domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature. The term "resident of a Contracting State" would not include, however, any person who is liable to tax in a country in respect only of income from sources in that country or capital situated therein.

In the case of income derived or paid by a partnership, estate, or trust, the term "resident of a Contracting State" would apply only to the extent that the income derived by such entity is subject to tax in that country as the income of a resident, either in the hands of the entity or in the hands of its partners or beneficiaries. For example, if the share of U.S. residents in the profits of a U.S. partnership is only one-half, the Czech Republic would have to reduce its withholding tax on only half of the Czech source income paid to the partnership.

This definition of the proposed treaty generally is based on the fiscal domicile article of the U.S. model and OECD model tax treaties and is similar to the provisions found in other U.S. tax treaties. Consistent with most U.S. income tax treaties, a U.S. citizen or U.S. green card holder would not be considered a U.S. resident unless he or she has a substantial presence, permanent home, or habitual abode in the United States. As a result, U.S. citizens residing overseas (in countries other than the Czech Republic) generally would not be entitled to the benefits of the proposed treaty as U.S. residents. This result is contrary to U.S. treaty policy as expressed in the U.S. model, although the U.S. policy is achieved in very few treaties.

The definition of the term "resident of a Contracting State" also would include a treaty country, or a political subdivision or a local authority thereof. It would also cover any agency or instrumentality of any such country, subdivision or authority.

Finally, the proposed treaty provides that a pension trust or other organization that is constituted and operated exclusively to provide pension benefits or for religious, charitable, scientific, artistic, cultural, or other educational purposes and that is a resident of a treaty country under its domestic laws would be considered a resident of that country for purposes of the proposed treaty, notwithstanding that all or part of the income of that person is exempt from tax in that country. This would apply, for example, in the case of a pension fund which generally is exempt from U.S. income tax under the Code.

The proposed treaty provides a set of "tie-breaker" rules to determine residence in the case of an individual who, under the basic treaty definition, would be considered a resident of both the United States and the Czech Republic. Such a dual resident individual would be deemed a resident of the country in which he or she has a permanent home available to him or her. If this permanent home

test is inconclusive because the individual has a permanent home in both countries, the country of residence would be deemed to be the country with which the individual's personal and economic relations are closer, i.e., his or her "center of vital interests." If the individual's center of vital interests cannot be determined, or if there is a permanent home available to the individual in neither country, then the country of residence would be deemed to be the country in which he or she has an habitual abode. If the individual has an habitual abode in both countries or in neither of them, the country of residence would be deemed to be the country of which he or she is a national. If the person is a national of both countries or of neither of them, the competent authorities of the countries would settle the question of residence by mutual agreement.

If a company would be considered a dual resident (i.e., a resident of both the United States and the Czech Republic) under the general residence provisions of the proposed treaty, then the country of residence for purposes of application of the treaty would be the country under the laws of which (including the laws of its political subdivisions) the company is created.[14] In the case of a person other than an individual or a company that is resident in both treaty countries under the general definition, the proposed treaty would require the competent authorities of the two countries to settle the question by mutual agreement and to determine how the proposed treaty would apply to that person.

Article 5. Permanent Establishment

The proposed treaty contains a definition of the term "permanent establishment" which, with certain exceptions, would follow the pattern of other recent U.S. income tax treaties, the U.S. model, and the OECD model.

The permanent establishment concept is one of the basic devices used in income tax treaties to limit the taxing jurisdiction of the host country and thus mitigate double taxation. Generally, an enterprise that is a resident of one treaty country would not be taxable by the other country on its business profits unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the reduced rates of, or certain exemptions from, tax provided for dividends, interest, and royalties would apply unless the income is attributable to the permanent establishment, in which case such items of income would be taxed as business profits. U.S. taxation of business profits is discussed under Article 7 (Business Profits).

In general, under the proposed treaty, a permanent establishment would be a fixed place of business through which an enterprise resident in one treaty country engages in business in the other country. A permanent establishment would include a place of management, a branch, an office, a factory, a workshop, and a mine, an oil or gas well, a quarry, or other place of extraction of natural resources. It also would include a building site or construc-

[14] Under U.S. law, a company is treated as a U.S. resident if it is created or organized under the laws of the United States or any State. Under Czech law, according to the Technical Explanation, a company is treated as a resident of the Czech Republic if its place of registration is in the Czech Republic. It may be that, due to the similarity in the determination of residence of a company under the laws of the two countries, there would be few actual cases where this provision of the proposed treaty would apply.

tion or installation project, or an installation or drilling rig or ship used for the exploration or exploitation of natural resources, provided that the activity lasts for more than 12 months. The proposed treaty's 12-month period is consistent with the period required in the U.S. model treaty in determining whether similar activities constitute a permanent establishment.

The Technical Explanation elaborates on the application of these rules. It provides that the 12-month threshold would apply separately to each individual site or project. The testing period would begin when work (including preparatory work) physically begins in the treaty country. A series of commercially and geographically interdependent contracts or projects would be treated as a single project.[15] If the 12-month period is exceeded, the site or project would constitute a permanent establishment from its first day.

Under a similar rule, the proposed treaty provides that the furnishing of services (including consultancy services) by an enterprise through employees or other personnel would constitute a permanent establishment if activities of that nature continue (either for the same or a connected project) within the treaty country for a period or periods aggregating more than 9 months in any 12 month period. A rule of this type is contained in neither the U.S. nor OECD model treaty.

Both of the above rules would be subject to a limitation under the proposed treaty. Under this limitation, a permanent establishment would not exist in any taxable year in which the activity (i.e., the building site or construction or installation project, etc., or the furnishing of services) continues for a period or periods aggregating less than 30 days in that year.

The general rule would be modified to provide that a fixed place of business that is used solely for specified activities would not constitute a permanent establishment. These activities include the use of facilities solely for storing, displaying, or delivering merchandise belonging to the enterprise or for the maintenance of a stock of goods or merchandise belonging to the enterprise solely for storage, display, or delivery, or solely for processing by another enterprise. These activities also include the maintenance of a fixed place of business solely for the purchase of goods or merchandise or for the collection of information, or solely for the purpose of carrying on, for the enterprise, any other similar activity of a preparatory or auxiliary character. In addition, these activities include the maintenance of a fixed place of business solely for any combination of the activities mentioned in this paragraph.

If a person has, and habitually exercises, the authority to conclude contracts in a treaty country on behalf of an enterprise of the other country, then the enterprise generally would be deemed to have a permanent establishment in the first country. This rule would not apply where the person's activities are limited to the activities specified in the previous paragraph which would not constitute a permanent establishment if carried on by the enterprise through a fixed place or business located in the first country (e.g., the purchase of goods or the collection of information). The pro-

[15] For example, the drilling of several oil and gas wells within the same geographic area or by the same person would be considered a single permanent establishment.

posed treaty contains the usual provision that this "agency" rule would not apply to create a permanent establishment 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 whether a company resident in one treaty country has a permanent establishment in the other country would be made without regard to the fact that the company is related to a company that is a resident of the other country or to a company that engages in business in that other country. The relationship of the two companies, thus, would not be relevant; only the activities of the company being tested would be relevant.

Article 6. Income from Real Property (Immovable Property)

This article covers income derived from the ownership of real (immovable) property. The rules governing income from the sale of real property are set forth in Article 13 (Gains).

Under the proposed treaty, income derived by a resident of one treaty country from real property situated in the other country would be taxable in the country where the real property is located. Income from real property specifically would include income from agriculture or forestry.

The term "real property" would have the meaning which it has under the law of the country in which the property in question is situated. The term in any case would include property accessory to real property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of real property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. Thus, income from real property would include royalties and other payments in respect of the exploitation of natural resources (e.g., oil). Ships, boats, and aircraft used in international traffic would not be real property.

The source country (i.e., the country where the real property is situated) could tax income derived from the direct use, letting, or use in any other form of real property. These rules that allow source-country taxation would also apply to the income from real property of an enterprise and to income from real property used for the performance of independent personal services.

Certain U.S. treaties and the U.S. model treaty permit residents of one treaty country to elect to be taxed on income from real property in the other country on a net basis (i.e., as if the income were attributable to a permanent establishment). The proposed treaty also would provide for such an election. For purposes of taxation by the United States, a net-basis election made by a taxpayer under the proposed treaty would be binding for the taxable year of the election and for all subsequent taxable years unless the U.S. competent authority agrees to its termination.

Under the article on gains (Article 13), gains from the alienation of real property also would be taxable by the country where the property is located. In addition, gains from the alienation of shares of certain corporations owning real property situated in a treaty country would be taxable in that country.

Article 7. Business Profits

U.S. Code rules

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

The taxation of income as U.S. business income or not varies depending upon whether the source of the income is U.S. or foreign. In general, U.S. source periodic income (such as interest, dividends, rents, and wages), and U.S. source capital gains are effectively connected with the conduct of a trade or business within the United States 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 of a person engaged in a trade or business in the United States is treated as effectively connected with the conduct of a trade or business in the United States (thus, it is said to be taxed as if it were business income under a limited "force of attraction" rule).

In the case of foreign persons other than insurance companies, 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. For such persons, 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 and interest either derived in the active conduct of a banking, financing or similar business in the United States, or received by a corporation the principal business of which is trading in stocks or securities for its own account; and certain sales income attributable to a U.S. sales office.

The foreign source income of a foreign corporation that is subject to tax under the insurance company provisions of the Code may be treated as effectively connected with a U.S. trade or business without regard to the foregoing rules, so long as such income is attributable to its U.S. business. In addition, the net investment income of such a company which must be treated as effectively connected with the conduct of an insurance business within the United States is not less than an amount based on a combination of asset/liability ratios and rates of return on investments experienced by the foreign person in its worldwide operations and by the U.S. insurance industry.

Trading in stocks, securities, or commodities in the United States for one's own account generally does not constitute a trade or business in the United States, and accordingly, income from those activities is not taxed by the United States as business income. Thus, income from 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 generally is not taxed as business income. This rule, however, generally does not apply to a dealer, or, in the case of trading in stocks or securities, to a corporation the principal business of which is trading in stocks or securities for its own account, if its principal office is in the United States.

The Code, as amended by the Tax Reform Act of 1986, provides that any income or gain of a foreign person for any taxable year which is attributable to a transaction in any other taxable year will be treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in that other taxable year (Code sec. 864(c)(6)). In addition, the Code provides that if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, the determination of whether any income or gain attributable to a sale or exchange of that property occurring within 10 years after the cessation of business is effectively connected with the conduct of trade or business within the United States shall be made as if the sale or exchange occurred immediately before the cessation of business (Code sec. 864(c)(7)).

Proposed treaty rules

Under the proposed treaty, business profits of an enterprise of one treaty country would be taxable in the other country *only* to the extent they are attributable to a permanent establishment in the other country through which the enterprise carries on (or has carried on) business. This is one of the basic limitations on a country's right to tax income of a resident of the other country. This rule would incorporate the concept of Code section 864(c)(6) with respect to deferred payments (which also is reflected in Articles 11 (Interest), 12 (Royalties), 14 (Independent Personal Services), and 22 (Other Income)). That is, if income was attributable to a permanent establishment or fixed base when earned, it would be taxable by the treaty country where the permanent establishment or fixed base was located, even if receipt of the income is deferred until the permanent establishment or fixed base has ceased to exist.

The taxation of business profits under the proposed treaty would differ from U.S. rules for taxing business profits primarily by requiring more than merely being engaged in trade or business before a treaty country could tax business profits and by substituting the "attributable to" standard for the Code's "effectively connected" standard. Under the Code, on the one hand, all that is necessary for effectively connected business profits to be taxed is that a trade or business be carried on in the United States. Under the proposed treaty, on the other hand, some level of fixed place of business (as detailed above in the discussion of Article 5 (Permanent Establishment)) would have to be present and the business profits would have to be attributable to that fixed place of business.

Under the proposed treaty, there would be attributed to a permanent establishment the business profits which might be expected to have been derived by it if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions. Amounts could be attributed whether they are

from sources within or without the country in which the permanent establishment is located.

In computing taxable business profits, deductions would be allowed for expenses, wherever incurred, which are incurred for the purposes of the permanent establishment. These deductions specifically would include a reasonable allocation of research and development expenses, interest, and other similar expenses and executive and general and administrative expenses. Thus, for example, a U.S. company that has a branch office in the Czech Republic but which has its head office in the United States would be entitled, in computing the Czech tax liability of the branch, to deduct the executive and general and administrative expenses incurred in the United States by the head office that are reasonably connected with generating the profits of the Czech branch.

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

The amount of profits attributable to a permanent establishment would include only the profits or losses derived from the assets or activities of the permanent establishment, and would be determined by the same method each year unless there is good and sufficient reason to change the method. Under this rule, the "limited force of attraction" concept of Code section 864(c)(3) would not be incorporated into the proposed treaty.

The proposed treaty specifies that nothing in Article 7 would affect the application of any internal law of a treaty country relating to the determination of the tax liability of a person in cases where the information available to the competent authority of that country is inadequate to determine the profits to be attributed to a permanent establishment. This rule would apply only if, on the basis of the available information, the determination of the profits of the permanent establishment is consistent with the principles of Article 7 of the proposed treaty.

Like some U.S. treaties and the U.S. model, the proposed treaty would define the term "business profits" as income derived from any trade or business. Business profits would include, for example, profits from manufacturing, mercantile, fishing, transportation, communication, or extractive activities. Business profits would also include the furnishing of personal services, including the furnishing by a corporation of the personal services of its employees. By contrast, business profits would not include income received by an individual for his performance of personal services either as an employee or in an independent capacity.

Where business profits include items of income which are dealt with separately in other articles of the proposed treaty, those other articles, and not Article 7, would govern the treatment of those items of income. Thus, for example, film rentals would be taxed (or exempted from tax) under the provisions of Article 12 (Royalties), and not taxed as business profits, except as provided in paragraph 4 of Article 12.

Article 8. Shipping and Air Transport

Article 8 of the proposed treaty covers income from the operation or rental of ships and aircraft, and profits from the use or rental of containers, trailers, barges, and related container transport equipment, in international traffic. The rules governing income from the disposition of ships, aircraft, and containers are in Article 13 (Gains).

As a general rule, the United States taxes the U.S. source income of a foreign person from the operation of ships or aircraft to or from the United States. An exemption from U.S. tax is provided if the income is earned by a corporation that is organized in, or an alien individual who is resident in, a foreign country that grants an equivalent exemption to U.S. corporations and residents. The United States has entered into agreements with a number of countries providing such reciprocal exemptions.

The proposed treaty provides that profits which are derived by an enterprise of one treaty country from the operation of ships or aircraft in international traffic ("shipping profits") would be exempt from tax by the other country, regardless of the existence of a permanent establishment in the other country. International traffic would mean any transportation by ship or aircraft of a resident of a treaty country, except where the transportation is solely between places in the other country (Article 3(1)(f) (General Definitions)).

For purposes of this article of the proposed treaty, the term "income from the operation of ships or aircraft in international traffic" would include profits derived from the leasing of a ship or aircraft on a full (time or voyage) basis (i.e., with crew). In addition, it would include profits generated from the leasing of ships or aircraft on a bareboat charter basis (i.e., without crew) if such leasing provides an occasional source of income to an enterprise engaged in the international operation of ships or aircraft.

Profits derived by an enterprise of a treaty country from the use, maintenance, or lease of containers (including trailers, barges, and related equipment for the transport of containers) used in international traffic would be taxable only by the country in which the recipient is a resident.

The exemption from source country tax also would apply to profits derived from the operation of ships and aircraft in international traffic through participation in a pool, a joint business, or an international operating agency.

This article on shipping and air transport would be subject to the provisions of the saving clause (paragraph 3 of Article 1). Thus, the United States generally could tax the income from the operation of ships or aircraft in international traffic derived by its citizens and residents, notwithstanding the provisions of this article.

Article 9. Associated Enterprises

The proposed treaty, like most other U.S. tax treaties, contains an arm's-length pricing provision similar to Code section 482. Under this provision of the proposed treaty, each country could make an allocation of income to that country in the case of transactions between related enterprises, if an allocation is necessary to reflect the conditions and arrangements which would have been made between independent enterprises. It is understood that this

provision would not limit the United States' right to apply the provisions of Code section 482 (and regulations promulgated thereunder) to residents of either treaty country or to the residents of third countries. Thus, the absence from this article of paragraph 3 of the corresponding article of the U.S. model is not intended to imply that the rule embodied in the latter is in any way inconsistent with, or different from, the rules embodied in Article 9 of the proposed treaty.

For purposes of the proposed treaty, an enterprise of one treaty country would be considered related to an enterprise of the other country if one of the enterprises participates directly or indirectly in the management, control or capital of the other enterprise. The enterprises also would be considered related if the same persons participate directly or indirectly in the management, control, or capital of both enterprises.

If, pursuant to the rules of the preceding paragraphs, a redetermination of tax liability is made by one treaty country, the other country generally would be obligated to make an appropriate adjustment (often referred to as a "correlative adjustment") to the amount of tax paid in that country on the redetermined income.[16] In determining this adjustment, due regard would be given to the other provisions of the proposed treaty and, if necessary, the competent authorities of the two countries would consult with one another. To avoid double taxation, the proposed treaty's saving clause which generally would permit a country to retain full taxing jurisdiction over its residents and citizens would not apply in the case of such adjustments.

The proposed treaty provides that a country would not be required to make a correlative adjustment if the case involves fraud, gross negligence, or willful default on the part of the taxpayer.

Article 10. Dividends

Internal dividend rules

United States

The United States generally imposes a 30-percent tax on the gross amount of U.S. source dividends (other than dividends paid by an "80/20 company" described in Code section 861(c)) paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In such a case, the foreign recipient is subject to U.S. tax, like a U.S. person, at the standard graduated rates, on a net basis.

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

[16] According to the Technical Explanation, it is understood that the other treaty country need adjust its tax only if it agrees that initial adjustment was appropriate.

paid on debt obligations carrying the right to participate in profits typically are treated as interest under U.S. law, and as a result, such amounts may in some cases be exempt under the Code from U.S. withholding tax (see discussion of interest in connection with Article 11, below).

U.S. source dividends generally are dividends paid by a U.S. corporation. Also treated as U.S. source dividends for this purpose are portions of certain dividends paid by a foreign corporation, 25 percent or more of whose gross income over a three-year testing period consists of income that is treated as effectively connected with the conduct of a U.S. trade or business. The U.S. source portion of such a dividend generally is equal to the total amount of the dividend, multiplied by the ratio over the testing period of the foreign corporation's U.S. effectively connected gross income to its total gross income. No tax is imposed, however, on a foreign recipient to the extent of such U.S. source portion unless a treaty prevents application of the statutory branch profits tax. The tax imposed on the latter dividends is often referred to as the "second-level" withholding tax.

Under proposed regulations, certain other payments that substitute for dividends in a securities lending transaction are treated as dividends for tax purposes.[17] These regulations cover cases where, for example, a foreign person owns dividend-paying stock in a U.S. corporation and "lends" the stock to a second person in exchange for a promise by the second person to make payments to the lender. The "borrower" collects the dividends paid with respect to the stock, and is required to make equivalent payments to the lender during the term of the "loan." This equivalent payment is referred to in the proposed regulations as a substitute dividend payment.

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

In general, corporations do not receive deductions for dividends paid under U.S. law. Thus, the withholding and branch taxes often represent imposition of a second level of tax on corporate taxable income. Treaty reductions of these taxes reflect the view that where, for example, the United States already imposes corporate level tax on the earnings of a U.S. corporation, a 30-percent withholding rate may represent an excessive level of source country taxation. Moreover, the 5-percent rate on dividends paid to direct investors which is found in many U.S. income tax treaties reflects the view that the source country tax on payments of profits to a sub-

[17] INTL-106-89, 1992-1 C.B. 1196. The proposed regulations would amend sections 1.861-2, 1.861-3, 1.871-2, 1.871-7, 1.881-2, 1.894-1, and 1.1441-2 of the Treasury regulations.

stantial foreign corporate shareholder may properly be reduced further to avoid double corporate-level taxation and to facilitate international investment.

A Real Estate Investment Trust (REIT) is a corporation, trust, or association that is subject to the regular corporate income tax, but that receives a deduction for dividends paid to its shareholders if certain conditions are met (Code sec. 857(b)). In order to qualify for the deduction for dividends paid, a REIT must distribute most of its income. Thus, a REIT is treated, in essence, as a conduit for federal income tax purposes. A REIT is organized to allow persons to diversify ownership in primarily passive real estate investments. Often, the principal income of a REIT is rentals from real estate holdings.

Because a REIT is taxable as a U.S. corporation, a distribution of earnings is treated as a dividend, rather than income of the same type as the underlying earnings. Distributions of rental income, for example, are not themselves considered rental income. This is true even though the REIT generally is not taxable at the entity level on the earnings it distributes. Because a REIT cannot be engaged in an active trade or business, its distributions are U.S. source and thus are subject to U.S. withholding tax of 30 percent when paid to foreign owners.

Like dividends, U.S. source rental income of foreign persons generally is subject to U.S. withholding tax at a statutory rate of 30 percent (unless, in the case of rental income, the recipient elects to have it taxed in the United States on a net basis at the regular income tax rates). Unlike the tax on dividends, however, the withholding tax on U.S. real property rental income generally is not reduced in U.S. income tax treaties.

The Code also generally treats Regulated Investment Companies (RICs) as both corporations and conduits for income tax purposes. The purpose of a RIC is to allow investors to hold a diversified portfolio of securities. Thus, the holder of stock in a RIC may be characterized as a portfolio investor in the stock held by the RIC, regardless of the proportion of the RIC's stock owned by the dividend recipient.

Czech Republic

It is understood that dividends received from Czech corporations generally are subject to a gross basis tax at a rate of 25 percent. The tax is levied on both resident and nonresident shareholders and is collected by withholding.

Treaty reduction of dividend taxes

Under the proposed treaty, dividends paid by a company that is a resident of one country to a resident of the other country would be taxable by both countries. The proposed treaty would limit, however, the rate of tax that the country of which the payor corporation is a resident (the "source country") may impose on dividends paid to a beneficial owner in the other country. None of the limitations on taxation of dividends would apply to taxation of the company in respect of the profits out of which the dividends are paid. The limitation would be 15 percent or 5 percent, depending on the relationship between the payor and the payee. With one exception

discussed below, the rate of source-country tax could never exceed 15 percent of the gross amount of the dividends. The 5-percent rate of source-country tax generally would apply to dividends if the beneficial owner is a company which owns at least 10 percent of the voting stock of the company paying the dividends. The 15-percent rate would apply to dividends in all other cases.

Notwithstanding the rules just described, the proposed treaty would permit imposition of the 15-percent tax rate on certain dividends paid to companies regardless of their level of ownership in the payor, and permit full operation of internal law on dividends paid to certain investors by REITs. A tax of up to 15 percent would be permitted to be imposed on all dividends paid by a RIC, and on dividends paid by a REIT to individuals that own less than 10-percent interests in the REIT. In the case of REIT distributions to other interest holders, the rate of withholding tax applicable under domestic law (currently 30 percent) would apply, rather than any reduced rate prescribed by the treaty.

Definition of dividends

The proposed treaty would define dividends to mean income from shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subject to the same tax treatment as income from shares by the laws of the source country. The term dividends, under the proposed treaty, also would include income from arrangements, including debt obligations, carrying the right to participate in profits, to the extent so characterized under the domestic law of the country in which the income arises. This definition of dividend would allow the United States to apply its domestic rules for determining whether an interest is debt or equity.

Branch profits tax

The proposed treaty would expressly permit the United States to collect the branch profits tax from a Czech company.[18] The United States would be allowed to impose the branch profits tax on a Czech corporation that either has a permanent establishment in the United States, or is subject to tax on a net basis in the United States on income from real property or gains from the disposition of interests in real property. The proposed treaty, however, would permit at most a 5-percent branch profits tax rate, and, in cases where a Czech corporation conducts a trade or business in the United States but *not* through a permanent establishment, the proposed treaty would completely eliminate the branch profits tax that the Code would otherwise impose on such corporation (unless the corporation earned income from real property as described above).

According to the Technical Explanation, it is understood that the U.S. branch profits tax imposed under the proposed treaty on a Czech company would be based on the company's dividend equivalent amount (as that term is defined under U.S. internal law).

None of the restrictions on the operation of the U.S. internal law branch profit tax provisions would apply, however, unless the cor-

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[18] It would also permit the Czech Republic to reciprocally impose a branch profits tax on U.S. companies if, under its internal laws, it imposes such a tax on all permanent establishments within its borders that are maintained by nonresident companies.

poration seeking treaty protection meets the conditions of the proposed treaty's limitation on benefits article (Article 17). As described in the discussion of Article 17 below, the limitation on benefits requirements of the proposed treaty are similar, but not identical, to the corresponding provisions of the branch profits tax provisions of the Code (sec. 884(e)).

Other rules

The reduced rates of tax on dividends would apply unless the beneficial owner of the dividends carries on or has carried on business through a permanent establishment (or fixed base in the case of an individual performing independent personal services) in the source country and the dividends are attributable to the permanent establishment (or fixed base). Dividends attributable to a permanent establishment would be taxed on a net basis as business profits (Article 7). Dividends attributable to a fixed base would be taxed on a net basis as income from the performance of independent personal services (Article 14).

A treaty country may tax dividends paid by a company resident in the other country, only in two cases: first, where its own resident receives the dividends; and second, where the holding in respect of which the dividends are paid forms part of the business property of a permanent establishment (or fixed base) situated in that country (even if the dividends paid consist wholly or partly of profits or income arising in that country).

The article on dividends would be subject to the provisions of the saving clause (Article 1, paragraph 3). Therefore, as a general rule, the United States could tax its citizens and residents on dividend income without regard to the provisions contained in the proposed treaty. Specifically, in the case of dividends paid by a U.S. company to a U.S. citizen resident in the Czech Republic, the U.S. tax would not be limited by the source country withholding limits contained in Article 10.

Article 11. Interest

Internal interest rules

United States

Subject to numerous exceptions (such as those for portfolio interest, bank deposit interest, and short-term original issue discount), the United States imposes a 30-percent tax, collected by withholding, on U.S. source interest paid to foreign persons under the same rules that apply to dividends. U.S. source interest, for purposes of the 30-percent tax, generally is interest on the debt obligations of a U.S. person, other than a U.S. person that meets the foreign business requirements of Code section 861(c) (a so-called "80/20 company"). Also subject to the 30-percent tax is interest paid by the U.S. trade or business of a foreign corporation. A foreign corporation is also subject to a branch-level excess interest tax, which is the tax the foreign corporation would have paid had a wholly owned domestic corporation paid it the interest deducted by the foreign corporation in computing its U.S. effectively connected income, but not actually paid by the U.S. trade or business (sec. 884(f)).

Portfolio interest generally is defined as any U.S. source interest that is not effectively connected with the conduct of a trade or business and (1) is paid on an obligation that satisfies certain registration requirements or specified exceptions thereto, and (2) is not received by a 10-percent owner of the issuer of the obligation, taking into account shares owned by attribution.[19]

Under a provision enacted in the Omnibus Budget Reconciliation Act of 1993, the portfolio interest exemption is inapplicable to certain contingent interest income. For this purpose, contingent interest generally includes interest determined by reference to any of the following attributes of the debtor or any related person: receipts, sales, or other cash flow; income or profits; or changes in the value of property. In addition, contingent interest generally includes interest determined by reference to changes in the value of, or yields on, certain actively traded property. In the case of an instrument on which a foreign holder earns both contingent and noncontingent interest, denial of the portfolio interest exemption applies only to the portion of the interest which is contingent interest.

If an investor holds an interest in a fixed pool of real estate mortgages that is a real estate mortgage interest conduit (REMIC), the REMIC generally is treated for U.S. tax purposes as a pass-through entity and the investor is subject to U.S. tax on some portion of the REMIC's income (which, in turn, generally is interest income). If the investor holds a so-called "residual interest" in the REMIC, the Code provides that a portion of the net income of the REMIC that is taxed in the hands of the investor—referred to as the investor's "excess inclusion"—may not be offset by any net operating losses of the investor, must be treated as unrelated business income if the investor is an organization subject to the unrelated business income tax under section 511, and is not eligible for any reduction in the 30-percent rate of withholding tax (by treaty or otherwise) that would apply if the investor were otherwise eligible for such a rate reduction.

Czech Republic

It is understood that interest arising from sources within the Czech Republic and received by nonresidents generally is subject to a gross-basis tax of 25 percent. The tax is collected by withholding.

Treaty elimination of interest taxes

Under the proposed treaty, interest arising in a treaty country and beneficially owned by a resident of the other country generally would be taxable *only* by that other country. In this respect, the proposed treaty is consistent with the U.S. model treaty position of eliminating source country withholding tax on interest. The reduced rate established by the proposed treaty would apply only if the interest is beneficially owned by a resident of the other country. Accordingly, it would not apply if the recipient is a nominee for a nonresident.

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[19] Certain additional exceptions to this general rule apply only in the case of a corporate recipient of interest. In such a case, the term portfolio interest generally excludes (1) interest received by a bank on a loan extended in the ordinary course of its business (except in the case of interest paid on an obligation of the United States), and (2) interest received by a controlled foreign corporation from a related person.

Notwithstanding the general rule prohibiting source country withholding taxes on interest, the proposed treaty would grant no reduction of U.S. withholding tax in the case of an excess inclusion with respect to a residual interest in a REMIC.

Definition of interest

The proposed treaty would define interest to mean income from debt-claims of every kind, whether or not secured by mortgage and, subject to the definition of the term "dividends" provided the article on dividends (Article 10, paragraph 4), whether or not carrying a right to participate in the debtor's profits. The term interest also would include, in particular, income from government securities and income from bonds or debentures (including premiums or prizes attaching to such securities, bonds, or debentures). It would also include all other income treated as interest by the tax law of the country in which the interest arises. Thus, the United States would be permitted to apply its domestic rules for determining whether an interest is debt or equity.

Branch-level excess interest tax

Because the proposed treaty would exempt from source country tax interest derived by a resident of the other treaty country, the United States would not impose the branch-level interest tax under Code section 884 on excess interest of a U.S. branch of a Czech company.

Source rule for interest

The proposed treaty provides a source rule for interest (which, it is understood, would not be relevant to Article 24 (Relief from Double Taxation) for foreign tax credit purposes). Interest would be deemed to arise within a country if the payor is a resident of that country. If, however, the interest expense is borne by (i.e., for purposes of computing taxable income, deductible by) a permanent establishment (or fixed base) that the payor has in the Czech Republic or the United States and the indebtedness was incurred with respect to that permanent establishment (or fixed base), then the interest would have as its source that country, regardless of the residence of the payor. Generally, this is consistent with U.S. source rules (secs. 861-862) which provide as a general rule that interest income is sourced in the country in which the payor is resident. Thus, for example, if a Swiss resident has a permanent establishment in the Czech Republic and that Swiss resident incurs indebtedness to a U.S. person for that Czech permanent establishment, and the permanent establishment bears the interest, then the interest would have its source in the Czech Republic.

Other rules

The elimination of source country tax would not apply if the recipient carries on or has carried on business through a permanent establishment, or performs or has performed services from a fixed base in the source country, and the interest is attributable to that permanent establishment or fixed base. In that event, the interest would be taxed as business profits (Article 7) or income from the performance of independent personal services (Article 14).

The proposed treaty addresses the issue of interest charges not at arm's length between parties having a direct or indirect special relationship by providing that the amount of interest for purposes of the treaty would be the amount of arm's-length interest. The amount of interest in excess of the arm's-length interest would be taxable according to the laws of each country, taking into account the other provisions of the proposed treaty (e.g., if interest in excess of the arm's-length amount paid to a shareholder were treated as a dividend under local law, it, thus, would be entitled to the benefits of Article 10 of the proposed treaty).

The article on interest would be subject to the provisions of the saving clause (Article 1, paragraph 3). Therefore, as a general rule, the United States would be permitted to tax its citizens and residents on interest income without regard to the provisions contained in the proposed treaty.

Article 12. Royalties

Internal royalty rules

United States

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

Czech Republic

Royalties and rents arising in the Czech Republic and received by foreign persons generally are subject to gross-basis tax of 25 percent. The tax is collected by withholding.

Taxation of royalties under the proposed treaty

The U.S. model treaty exempts royalties from tax at source. The proposed treaty, conversely, would allow limited source country taxation of certain royalties. Generally, royalties from sources (under the royalty source rule discussed below) in one country that are beneficially owned by a resident of the other country would be taxable by both countries. As an exception to this general rule, royalties received in consideration for the use of, or for the right to use, any copyright of literary, artistic or scientific work, including cinematographic films or films or tapes and other means of image or sound reproduction would be taxable only by the country in which the recipient is a resident. All other royalties arising from sources in one treaty country and beneficially owned by a resident of the other country would be taxable in the source country at a rate not in excess of 10 percent of the gross amount of the royalties. The rate limitation and exemption in the proposed treaty would apply only if the royalty is beneficially owned by a resident of the other country; they would not apply if the recipient is a nominee for a nonresident.

Definition of royalties

Royalties would be defined to mean payments of any kind received in consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including cinematographic films or films or tapes and other means of image or sound reproduction. Royalties would also include payments for the use of, or the right to use, any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience. The definition of the term "royalties" also would include payments derived from the alienation of any such right or property to the extent contingent on the productivity, use, or further disposition thereof. Similar gains that are not so contingent would be subject to the rules of the article on gains (Article 13).

Source rules for royalties

The proposed treaty provides special source rules for royalties. Generally under U.S. tax rules (secs. 861-862), royalty income is sourced where the property or right is being used. As a general rule under the proposed treaty, if the payor of a royalty is the government of one of the treaty countries (or a political subdivision or local authority thereof) or a resident of that country for purposes of its tax, the royalty would be sourced in that country. If the payor of a royalty (whether or not a resident of one of the countries) has a permanent establishment or fixed base in the United States or the Czech Republic in connection with which the liability to pay the royalty was incurred, and if the royalties are borne by the permanent establishment or fixed base, the royalties would be deemed to arise (for purposes of the proposed treaty) in the country in which the permanent establishment or fixed base is situated. Finally, in situations where the payor of a royalty is not a resident of either country and the royalty is not borne by a permanent establishment or a fixed base located in either country, but the royalty relates to the use of, or the right to use, in one of the countries, property described in the proposed treaty's definition of the term "royalty," the royalty would be sourced in that country of use.

The proposed treaty's source rules for royalties detailed above would be applicable only for purposes of determining whether royalties are taxable in the country of source under Article 12. It is understood that these rules would not apply with respect to the determination of source for purposes of the permitting a foreign tax credit under the article for relief from double taxation (Article 24).

Other rules

Neither the reduced withholding tax rate nor the exemption would apply where the beneficial owner of the royalties carries on or has carried on business through a permanent establishment in the source country or performs or has performed personal services in an independent capacity from a fixed base in the source country, and the royalties are attributable to the permanent establishment or fixed base. In that event, the royalties would be taxed as business profits (Article 7) or income from the performance of independent personal services (Article 14).

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

The article on royalties would be subject to the provisions of the saving clause (Article 1, paragraph 3). Therefore, as a general rule, the United States would be permitted to tax its citizens and residents on royalty income without regard to the provisions contained in the proposed treaty. Specifically, in the case of a royalty from a U.S. company accruing to a beneficial owner who is a U.S. citizen resident in the Czech Republic, the U.S. tax would not be limited by the source country withholding limits contained in Article 12.

Article 13. Gains

Internal capital gains rules

United States

Generally, gain realized by a nonresident alien or a foreign corporation from the sale of a capital asset is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S. trade or business or, in the case of a nonresident alien, he or she is physically present in the United States for at least 183 days in the taxable year. However, under the Foreign Investment in Real Property Tax Act of 1980, as amended ("FIRPTA"), a nonresident alien or foreign corporation is taxed by the United States on gain from the sale of a U.S. real property interest as if the gain were effectively connected with a trade or business conducted in the United States. "U.S. real property interests" include interests in certain corporations holding U.S. real property.

Czech Republic

It is understood that the Czech Republic generally does not tax capital gains of foreign persons; e.g., no tax is levied on gains of such a person arising from the disposition of shares of a Czech corporation.

Treatment of gains under the proposed treaty

Under the proposed treaty, only certain gains would be taxable in the source country. Gains derived by a resident of one treaty country from the alienation of real property would be taxable in the country where the real property is situated. For this purpose, real property situated in the other country would include real property as defined in Article 6 (Income from Real Property (Immovable Property)) which is situated in that other country. It also would include shares of stock of a company the property of which consists at least 50 percent of real property situated in that other country, as well as an interest in a partnership, trust or estate to the extent that the assets of that entity consist of real property situated in that other country.

According to the Technical Explanation, real property situated in the United States under the proposed treaty would include in all cases a United States real property interest as defined in Code section 897(c). This definition would allow the United States to tax any transaction of a Czech resident that is taxable under FIRPTA.

Gains from the alienation of personal (movable) property which are attributable to a permanent establishment which an enterprise of a treaty country has or had in the other country, or which are attributable to a fixed base which is or was available to a resident of a treaty country in the other country for the purpose of performing independent personal services, and gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or such a fixed base, would be taxable in that other country.

Gains derived by an enterprise of one country from the sale or exchange of ships, aircraft or containers used in international traffic would be taxable only by the country of the enterprise's residence. The ships, aircraft, and containers whose disposition would be exempt from source country gains tax under this provision corresponds to the property the profits from which would be exempt from source country tax under the article on shipping and air transport (Article 8).

Gains contingent on the productivity, use, or further disposition of rights or property, and therefore described as royalties under Article 12 (Royalties), would be taxable only in accordance with the provisions of that article.

Gains from the alienation of any property other than property discussed above would be taxable under the proposed treaty only in the country where the alienator is a resident.

The article on gains would be subject to the provisions of the saving clause (Article 1, paragraph 3). Therefore, as a general rule, the United States would be allowed to tax its citizens and residents on gains without regard to the provisions contained in the proposed treaty. For example, in the case of a gain from the alienation of ships, aircraft, or containers, recognized by a U.S. citizen resident in the Czech Republic, the United States would not be limited in its ability to tax such gain by the provisions contained in Article 13.

Article 14. Independent Personal Services

Internal rules regarding services income in general

United States

The United States taxes the income of a nonresident alien at the regular graduated rates if the income is effectively connected with the conduct of a trade or business in the United States by the individual. (See discussion of U.S. taxation of business profits under Article 7 (Business Profits).) The performance of personal services within the United States can constitute a trade or business within the United States (Code sec. 864(b)).

Under the Code, the income of a nonresident alien individual from the performance of personal services in the United States is excluded from U.S. source income, and therefore is not taxed by the United States in the absence of a U.S. trade or business, if certain criteria are met. The criteria are: (1) the individual is not in the

United States for over 90 days during a taxable year, (2) the compensation does not exceed $3,000, and (3) the services are performed as an employee of or under a contract with a foreign person not engaged in a trade or business in the United States, or they are performed for a foreign office or place of business of a U.S. person. If these criteria are not satisfied, then the income is taxed at the regular graduated rates that apply to U.S. persons.

Czech Republic

Individuals generally are subject to tax in the Czech Republic with respect to income derived from the performance of personal services. The tax rate on such income ranges from 15 to 47 percent.

Income earned by nonresident individuals from employment in the Czech Republic is not subject to Czech tax if the following conditions are met: (1) the individual is present in the Czech Republic for less than 183 days during the taxable year; (2) the employer is not a resident of the Czech Republic; (3) the services are not performed at a branch or office of the employer situated in the Czech Republic; and the employer does not have a contract lasting more than 6 months in any 18 month period under which business, technical, consulting or management services are provided to a person in the Czech Republic and which involve members of the employer's workforce being present in the country.

Treatment of independent personal services under the proposed treaty

The proposed treaty would limit the right of a treaty country to tax income from the performance of personal services by a resident of the other country. Under the proposed treaty, income from the performance of independent personal services would be treated separately from income from the performance of personal services as an employee (which is dealt with in Article 15 (Dependent Personal Services)).

Income from the performance of independent personal services in one country (the "source country") by a resident of the other country would be exempt from tax in the source country, unless either of two thresholds is met. Under the first, the source country could tax such income if the individual has or had a fixed base regularly available to him or her in that country for the purpose of performing the services.[20] In such case, the source country could tax only that portion of the individual's income that is attributable to the fixed base. Under the second, the source country could tax such income if the individual is present there for a period or periods exceeding in the aggregate 183 days in any twelve month period.

Independent personal services would include especially independent scientific, literary, artistic, educational, and teaching activities, as well as independent services of physicians, lawyers, engineers, architects, dentists, and accountants. The foregoing list is not exhaustive.

The article on independent personal services would be subject to the provisions of the saving clause (Article 1, paragraph 3). There-

[20] This rule would incorporate the concept of Code section 864(c)(6) with respect to deferred payments (which also is reflected in Articles 7 (Business Profits), 11 (Interest), 12 (Royalties), and 22 (Other Income)).

fore, as a general rule, the United States would be permitted to tax its citizens and residents on income derived from the performance of independent personal services without regard to the provisions contained in the proposed treaty. For example, in the case of such income earned by a U.S. citizen resident in the Czech Republic, the U.S. tax would not be limited by the rules contained in Article 14.

Article 15. Dependent Personal Services

Under the proposed treaty, income from services performed as an employee in one treaty country (the source country) by a resident of the other country generally would be taxable by both countries; however, only the country of residence could tax the income if three requirements are met: (1) the individual is present in the source country for fewer than 184 days during any 12-month period; (2) his or her employer is not a resident of the source country; and (3) the compensation is not borne (i.e., deducted by) by a permanent establishment or fixed base of the employer in the source country.

Compensation derived by an employee in respect of employment as a member of the regular complement (i.e., a member of the permanent crew) of a ship or aircraft operated in international traffic by an enterprise of one of the treaty countries would be taxable only by that country. Under the U.S. model treaty, by contrast, only the country where the employee resides may tax the income.

The provisions of this article would be modified in some respects for directors' fees (Article 16), pensions (Article 20) and compensation derived by students, trainees, teachers, and researchers (Article 21).

The article on dependent personal services is subject to the provisions of the saving clause (Article 1, paragraph 3). Therefore, as a general rule, the United States may tax its citizens and residents on employment income without regard to the provisions contained in the proposed treaty. For example, in the case of such income earned by a U.S. citizen resident in the Czech Republic, the U.S. tax is not limited by the rules contained in Article 16.

Article 16. Directors' Fees

The proposed treaty contains a special rule for directors' fees. If an individual who is a resident of one treaty country serves as a member of the board of directors or another similar organ of a company that is a resident of the other country, the country of the company's residence would be allowed to tax the fees and similar payments paid to the individual for such services to the extent attributable to services performed in that country. This rule follows the OECD model, except that under the OECD model, the country of residence of the company could tax the fees or similar payments regardless of where the related services are performed. There is no corresponding rule in the U.S. model treaty.

Article 17. Limitation on Benefits

In general

The proposed treaty contains a provision intended to limit the benefits of the treaty to persons who are entitled to them generally

by reason of their residence in the United States or the Czech Republic.

The proposed treaty is intended to limit double taxation caused by the interaction of the tax systems of the United States and the Czech Republic as they apply to residents of those 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 treaty country seeks certain benefits under the income tax treaty between the two countries. Under certain circumstances, and without appropriate safeguards, the third-country resident may be able to secure these benefits indirectly by establishing a corporation (or other entity) in one of the treaty countries which entity, as a resident of that country, is entitled to the benefits of the treaty. Additionally, it may be possible for the third-country resident to reduce the income base of the treaty country resident by having the latter pay out interest, 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 anti-treaty shopping article provides that a person that is a resident of either the Czech Republic or the United States and derives income from the other treaty country would be entitled to the benefits of the treaty only if that person is an individual, unless it satisfies an active business test, an ownership/"base erosion" test, or a public company test, or unless it is itself one of the treaty countries or a political subdivision or local authority thereof, or else is a not-for-profit, tax-exempt organization that also satisfies an ownership test. Finally, a company that fails to satisfy any of the above tests would still be permitted to obtain benefits under the treaty if agreed to by the competent authority of the treaty country in which the income at issue arises.

Active business test

Under the active business test, if the income derived in the other country is derived in connection with, or is incidental to, the active conduct by such person of a trade or business in the country of residence (other than the business of making or managing investments by a person other than a bank or insurance company), then no limitation on treaty benefits would apply. Under this test, the income would not have to be attributable to a permanent establishment in the country in which the income arises. Rather, it only has to be derived by a resident of one of the countries in connection with, or incidental to, the active conduct of a trade or business in that country. The Technical Explanation provides that the first six examples in the Memorandum of Understanding Regarding the Scope of the Limitation on Benefits Article in the Convention Between the Federal Republic of Germany and the United States of America (i.e., the U.S.-German income tax treaty) illustrate the situations covered by the active business test of the proposed treaty.

Ownership/base erosion test

A person also would qualify for treaty benefits if it satisfies both an ownership test and a base erosion test. Under the ownership test, more than 50 percent of the beneficial interest (in the case of a company, more than 50 percent of the number of shares of each class of shares) in that entity must be owned (directly or indirectly) by any combination of one or more persons that meet any of the other limitation on benefits tests (other than the active business test). In order to satisfy the base erosion test, not more than 50 percent of the gross income of the entity may be used (directly or indirectly) to meet liabilities (including liabilities for interest and royalties) to persons other than those that meet any of the other limitation on benefits tests (other than the active business test). This provision would, for example, deny the benefits of the reduced U.S. withholding tax rates on dividends, interest and royalties to a Czech company that is owned by individual residents of a third country.

In applying the base erosion test, the proposed treaty specifies that the term "gross income" would mean gross receipts. Where the enterprise is engaged in a business which includes the manufacture or production of goods, that term would mean gross receipts reduced by the direct costs of labor and materials attributable to such manufacture or production and paid or payable out of such receipts.

Public company test

Under the public company test, a company resident in a treaty country that has substantial and regular trading in its principal class of stock on a recognized securities exchange (a term defined in the proposed treaty) would be entitled to the benefits of the treaty regardless of where its actual owners reside. In addition, the public company test would be satisfied if the company is wholly owned (directly or indirectly) by a resident of the same treaty country in whose principal class of shares there is such substantial and regular trading on a recognized securities exchange.

Under the proposed treaty, the term "recognized stock exchange" means the NASDAQ System owned by the National Association of Securities Dealers, Inc. and 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 Czech stock exchange (Burza Cennycn Papiru Praha, A.S.) and any other stock exchange approved by the authorities of that country; and any other stock exchange that is agreed upon by the competent authorities of the two countries.

Tax-exempt entity

An entity that is a not-for-profit organization (including a pension fund or private foundation) and that, by virtue of that status, generally is exempt from income taxation in its residence country, provided that more than half of the beneficiaries, members, or participants, if any, in such an organization are entitled to benefits under the treaty, would qualify for treaty benefits.

Competent authority relief

An alternative would be provided for persons that do not satisfy any of the tests previously discussed. Under this alternative, such a person would be granted treaty benefits if the competent authority of the treaty country in which the income at issue arises so determines.

Article 18. Artistes and Sportsmen

The proposed treaty contains an additional set of rules which apply to the taxation of income earned by entertainers (such as theater, motion picture, radio or television "artistes" or musicians) and sportsmen (e.g., athletes). These rules apply notwithstanding the other provisions dealing with the taxation of income from personal services (Articles 14 and 15) and are intended, in part, to prevent entertainers and sportsmen from using the treaty to avoid paying any tax on their income earned in one of the countries.

Under the proposed treaty, one treaty country would be allowed to tax an entertainer or sportsman who is a resident of the other country on the income from his or her personal activities as an entertainer or sportsman in that country during any year unless the gross receipts that he or she derives from such activities, including reimbursed expenses, do not exceed $20,000 or its equivalent in Czech crowns for the taxable year. (The U.S. model treaty contains an identical $20,000 threshold.) Thus, if a Czech entertainer maintained no fixed base in the United States and performed (as an independent contractor) for two days in one taxable year in the United States for total compensation of $20,000, the United States could not tax that income. If, however, that entertainer's total compensation were $30,000, the full $30,000 (less appropriate deductions) would be subject to U.S. tax. As in the case of the other provisions dealing with personal services income, this provision would not bar the country of residence from also taxing that income.

Failure to exceed the $20,000 threshold would not preclude the source country from imposing withholding taxes on income of artistes and sportsmen, if such imposition is sanctioned under that country's domestic laws. To the extent that the amount of tax withheld in such a case exceeds the actual amount of tax due, such excess would be refunded to the taxpayer.

In addition, the proposed treaty provides that where income in respect of personal services performed by an entertainer or sportsman accrues not to that person but rather to another person or entity, that income would be taxable by the country in which the services are performed in any situation where the entertainer or sportsman shares directly or indirectly in the profits of the person or entity receiving the income. (This provision would apply notwithstanding Articles 7 and 14.) For this purpose, participation in the profits of the recipient of the income would include the receipt of deferred compensation, bonuses, fees, dividends, partnership distributions, or other distributions. The provision would not apply if it is established that neither the entertainer or sportsman, nor related persons, participate directly or indirectly in the profits of the person or entity receiving the income in any manner. This provision is intended to prevent highly paid performers and sportsmen from avoiding tax in the country in which they perform by routing

the compensation for their services through a third person such as a personal holding company or trust located in a country that would not tax the income.

Notwithstanding the above provisions, the proposed treaty provides that income derived by a resident of one of the countries as an entertainer or sportsman would be exempt from tax by the other country if the person's visit to the other country is substantially supported by public funds of his or her country of residence (or of a political subdivision or local authority thereof) or if made pursuant to a specific arrangement agreed to by the governments of the two countries.

The artistes and sportsmen article would be subject to the provisions of the saving clause (Article 1, paragraph 3). Therefore, as a general rule, the United States could tax its citizens and residents on income earned as an entertainer or sportsman without regard to the provisions contained in the proposed treaty. For example, in the case of such income earned by a U.S. citizen resident in the Czech Republic, the U.S. tax on that income would not be limited by the rules contained in Article 18.

Article 19. Pensions, Annuities, Alimony, and Child Support Pensions

Under the proposed treaty, pensions and other similar remuneration derived and beneficially owned by a resident of a treaty country in consideration of past employment by that person (or by another individual resident of the same country) would be subject to tax only in that country. (A different rule would apply in the case of pensions that are paid to citizens of one country attributable to services performed by the individual for government entities of the other (Article 20 (Governmental Service)). The saving clause would allow each country to continue to tax its citizens who are residents of the other country on pensions and similar remuneration.

Payments under the Social Security legislation of a treaty country and similar public pension payments made to a resident of the other country or to a U.S. citizen would be taxable only by the country making such payments. The staff understands that this rule would cover benefits under the social security programs of both the United States and the Czech Republic, as well as certain U.S. Railroad Retirement benefits. This provision would not be subject to the proposed treaty's saving clause.

Annuities

The proposed treaty also provides that (subject to the saving clause) annuities would be taxed by only the country of residence of the person who derives and beneficially owns them. Annuities would be defined as stated sums paid periodically at stated times during a specific number of years, under an obligation to make the payments in return for adequate and full consideration (other than services rendered).

Alimony

The proposed treaty provides that deductible alimony paid to a resident of one of the treaty countries generally would be taxable

only by that country.[21] The proposed treaty would define alimony to mean periodic payments made pursuant to a written separation agreement or decree of divorce, separate maintenance, or compulsory support that are taxable to the recipient under the laws of his or her country of residence. The saving clause generally would apply to alimony payments, so that the United States could tax such payments made to U.S. citizens resident in the Czech Republic.

Notwithstanding the foregoing rule, nondeductible alimony paid by a resident of one treaty country to a resident of the other country would not be taxable in that other country. This particular rule would not be subject to the saving clause.

Child support

The proposed treaty provides that child support payments paid by a resident of one treaty country to a resident of the other country would not be taxable in that other country. The proposed treaty would define child support to mean periodic payments, made pursuant to a written separation agreement or decree of divorce, separate maintenance, or compulsory support, for the support of a child. As in the U.S. model, the saving clause would not apply to child support payments. However, the United States generally does not treat child support payments as income.

Article 20. Government Service

The proposed treaty contains the standard provision that generally exempts the wages of certain employees of one of the countries from tax by the other country. Under the proposed treaty, remuneration, including a pension, paid from the public funds of a treaty country (or its political subdivision or local authority) to a citizen of that country for services rendered in the discharge of functions of a governmental nature would be taxable only in that country. This provision is identical to the provision of the U.S. model treaty.

If a country or one of its political subdivisions or local authorities is carrying on a business (as opposed to functions of a governmental nature) the provisions of Articles 14 (Independent Personal Services), or 18 (Artistes and Sportsmen) would apply, as appropriate, to remuneration paid from its public funds for services rendered in connection with the business.

The provisions of the proposed treaty relating to government service would be subject to the provisions of the modified saving clause (Article 1, paragraphs 3 and 4). That is, the general saving clause would apply except with respect to individuals who are neither citizens of, nor have immigrant status in, that country. With respect to the United States, the modified saving clause would apply only to U.S. citizens and persons having immigrant status in the United States (i.e., "green card" holders).

Article 21. Students, Trainees, Teachers, and Researchers

Under the proposed treaty, an individual who is a resident of one of the treaty countries at the beginning of his or her visit to the

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[21] Under U.S. law, the payment of alimony generally is deductible.

other country and who is temporarily present in that other country for the primary purpose of (1) studying at a university or other accredited educational institution in that other country, (2) securing training required to qualify him or her to practice a profession or professional specialty, or (3) studying or doing research as a recipient of a grant, allowance, or award from a governmental, religious, charitable, scientific, literary, or educational organization would be exempt from tax in that other country with respect to the amounts described below for a period not to exceed five years from the date of his or her arrival in that other country. The amounts referred to in the preceding sentence are (1) payments from abroad, other than compensation for personal services, for the purpose of the person's maintenance, education, study, research, or training, (2) the grant, allowance, or award, and (3) income from personal services performed in that other country in an aggregate amount not in excess of $5,000 (or its equivalent in Czech crowns) for any taxable year.

Similar rules are provided under the proposed treaty with respect to trainees. A special tax exemption would apply to an individual who is a resident of one of the treaty countries at the beginning of his or her visit to the other country and who is temporarily present in that other country as an employee of, or under contract with, a resident of the first-mentioned country, for the primary purpose of either acquiring technical, professional, or business experience from a person other than that employer (or person with whom he or she is under contract), or studying at a university or other accredited educational institution in that other country. In such cases, the person would be exempt from tax by that other country for a period of up to 12 consecutive months with respect to income from personal services in an aggregate amount of no more than $8,000 (or its equivalent in Czech crowns).

In addition, an individual who is a resident of one of the treaty countries at the time he or she becomes temporarily present in the other country, for a period of no more than 1 year, as a participant in a program sponsored by the Government of that other country for the primary purpose of training, research, or study would be exempt from tax in that other country with respect to his or her income from personal services in respect of such training, research, or study performed in that other country. The exemption would not apply with respect to income in excess of $10,000 (or its equivalent in Czech crowns).

The proposed treaty would grant specific authority to the competent authorities of the United States and the Czech Republic to agree to change any of the foregoing dollar (and equivalent Czech crown) thresholds if necessary to reflect significant changes in price levels.

A host country tax exemption also would be provided under the proposed treaty in the case of an individual who visits a treaty country for the primary purpose of teaching or conducting research at a university, college, school, or other accredited educational or research institution located there, and who is, immediately before the visit, a resident of the other country. This exemption would apply for a period not to exceed two years and would apply only with respect to remuneration for such teaching or research. The

benefits of this provision, however, would not be granted to an individual who, during the immediately preceding period enjoyed the benefits described in the preceding paragraphs relating to students, trainees, teachers, and researchers. Moreover, an individual would be entitled to the benefits described in this paragraph only once.

The proposed treaty specifies that the above rules would not apply to income from the performance of research, if the research is undertaken not in the public interest, but primarily for the private benefit of a specific person or persons.

The provisions of this article of the proposed treaty would be subject to the provisions of the modified saving clause (Article 1, paragraphs 3 and 4). That is, the general saving clause would apply except with respect to individuals who are neither citizens of, nor have immigrant status in, that country. With respect to the United States, the modified saving clause would apply only to U.S. citizens and persons having immigrant status in the United States. Thus, for example, the provisions of Article 21 which would exempt a resident of the Czech Republic from taxation as a student or trainee in the United States would be overridden by the saving clause if that person is either a citizen of the United States or holds a green card.

Article 22. Other Income

This article is a catch-all article intended to cover items of income not specifically covered in other articles of the proposed treaty, and to assign the right to tax third-country income to only one of the countries.[22] It would apply to income from third countries as well as income from the United States and the Czech Republic. This provision of the proposed treaty is substantially the same as the corresponding provision of the U.S. model treaty.

As a general rule, items of income, wherever arising, of a resident of a treaty country that would not otherwise be dealt with in the proposed treaty would be taxable only by the country of residence. In general, the proposed treaty, thus, would give the United States the sole right to tax income arising in a third country and paid to a resident of the United States. If the income is attributable to a permanent establishment or fixed base in the treaty country that is not the residence country, however, that country could also tax it pursuant to the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be. In addition, income from real property that is not subject to another treaty provision would be taxable only in the country of residence of the person earning the income, whether or not the real property income is attributable to a permanent establishment or fixed base in the other treaty country. The effect of this provision would be to allow only the residence country to tax income from real property located in a third country, even if that income somehow is attributable to a permanent establishment or fixed base in the other treaty country.

[22] The Technical Explanation identifies as types of income that would be subject to this article, lottery winnings, punitive damages, and cancellation of indebtedness income.

This provision would be subject to the saving clause, so U.S. citizens and residents who are also Czech residents would continue to be subject to U.S. taxation on their worldwide income.

Article 23. Capital

Many countries impose a tax on capital in addition to imposing a tax on income. As a general rule, taxes are imposed when the income from the capital would be taxed by the other country imposing the capital tax. The United States does not currently impose a tax on capital; however, the Czech Republic does. Under Article 2 (Taxes Covered), the Czech tax on immovable property would be a covered tax. Article 23, therefore, would apply to that tax.

Under the proposed treaty, capital could be taxed by the country in which located if it is real property owned by a resident of either country, or if it is personal (movable) property forming part of the business property of a permanent establishment or fixed base maintained by a resident of the other country. The owner's country of residence could also tax that property. The exclusive right to tax ships, aircraft, containers, and related personal property operated in international traffic would belong to the country of residence of the enterprise operating or using the property. All other capital would be taxable only in the country of residence.

This article of the proposed treaty is similar to the corresponding articles of the U.S. and OECD model treaties.

Article 24. Relief from Double Taxation

In general

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

Internal rules regarding the relief from double taxation

United States

The United States taxes the worldwide income of its citizens and residents. It attempts unilaterally to mitigate double taxation generally by allowing taxpayers to credit the foreign income taxes that they pay against U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets U.S. tax on foreign source income only. This limitation generally 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, subject to the separate limitation rules discussed below.

The foreign tax credit limitation is computed separately for certain classifications of income (e.g., passive income, high withholding tax interest, financial services income, shipping income, dividends from noncontrolled section 902 corporations, DISC dividends, FSC dividends, and taxable income of a FSC attributable to foreign trade income) in order to prevent the crediting of foreign taxes on certain types of traditionally high-taxed foreign source income against the U.S. tax on certain items of traditionally low-taxed foreign source income. Also, a special limitation applies to the credit for foreign taxes imposed on oil and gas extraction income.

Foreign tax credits generally cannot exceed 90 percent of the pre-foreign tax credit tentative minimum tax (determined without regard to the net operating loss deduction). The 90-percent alternative minimum tax foreign tax credit limitation, enacted in 1986, overrode contrary provisions of then-existing treaties.

An indirect or "deemed-paid" credit is also provided. A U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation (or an inclusion of the foreign corporation's income) is deemed to have paid a portion of the foreign income taxes paid (or deemed paid) by the foreign corporation on its earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid for the year the dividend is received and go into the relevant pool or pools of separate limitation category taxes to be credited.

Czech Republic

Czech residents are subject to tax on their worldwide income. A credit is allowed for foreign taxes paid on foreign source income.

Proposed treaty rules for the relief from double taxation

The proposed treaty sets forth separate rules, in recognition of the disparate internal taxation regimes of the two treaty countries, designed to address the problem of double taxation. In addition, it provides special rules covering U.S. citizens resident in the Czech Republic. The provisions of this article would not be subject to the proposed treaty's saving clause. Thus, the saving clause could not be used by the United States, for example, to deny a U.S. citizen or resident the benefits of this article.

United States

The proposed treaty contains a provision like that found in many U.S. income tax treaties that would require the United States to allow a U.S. citizen or resident a foreign tax credit for income taxes paid to the Czech Republic by or on behalf of such person.[23] The credit would be computed in accordance with the provisions, and subject to the limitations, of U.S. law (as those provisions and limitations may change from time to time without changing the general principles of the credit). Thus, for example, the credit granted by the United States under the proposed treaty would be subject to the overall foreign tax credit limitation, the alternative minimum

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[23] According to the Technical Explanation, it was the understanding of the treaty negotiators that the Czech income tax covered in Article 2 is a creditable tax under internal U.S. law.

tax foreign tax credit limitation, and the limitations imposed on each separate foreign tax credit category. This provision is similar to that found in many U.S. income tax treaties.

Czech Republic

The proposed treaty generally provides that in taxing a Czech resident, the Czech Republic could include in its tax base income that the United States may tax under the proposed treaty, but that if the Czech Republic does so, it would be required to allow as a deduction from Czech tax on the income (i.e., as a credit) an amount equal to the income tax actually paid in the United States (other than solely on the basis of citizenship). This deduction could not exceed, however, the portion of the Czech tax, as computed prior to the deduction, which is appropriate to the income taxable in the United States (other than solely on the basis of citizenship). In effect, the Czech Republic would limit its foreign tax credit on a per-country basis with respect to the United States under the proposed treaty.

Special rules for U.S. citizens who reside in the Czech Republic

In the case of a U.S. citizen residing in the Czech Republic, the proposed treaty provides that items of income which could be taxed by the United States solely by reason of citizenship (under the saving clause) would be sourced in the Czech Republic to the extent necessary to avoid double taxation. In no event, however, would the tax paid to the United States be less than the tax that would be paid if the individual were not a U.S. citizen.

To illustrate this provision, assume that a U.S. citizen who resides in the Czech Republic receives $200 of portfolio dividend income from a U.S. company. Absent the proposed treaty's saving clause (which would allow the United States to tax the dividend income as if the treaty were not in effect), the maximum amount of tax that could be imposed by the United States would be $30 (based on the 15-percent rate mandated under Article 10 (Dividends)). In computing the individual's Czech income tax on the dividend income, the general double tax relief provisions of the proposed treaty would require the Czech Republic to allow a credit against its tax for the U.S. tax. Thus, the income recipient would pay Czech tax appropriate to the dividend only if the pre-credit amount of that Czech tax exceeds $30.

In computing the individual's U.S. tax liability on the dividend income, the proposed treaty would require the United States to treat the dividend as foreign source income so as to allow a credit for any Czech tax paid, but only to the extent necessary to avoid double taxation of that income and, in no case, to reduce the U.S. tax liability with respect to that income below the $30 withheld at source.

Article 25. Non-Discrimination

The proposed treaty contains a non-discrimination provision similar to provisions which are embodied in other recent U.S. income tax treaties. This non-discrimination provision would apply not just to the taxes that the treaty covers generally, but to all

taxes that either country or any of its political subdivisions or local authorities impose.

In general, under the proposed treaty, a treaty country could not discriminate by imposing more burdensome taxes (or requirements connected with taxes) on nationals of the other country than on its own nationals in the same circumstances. This provision would apply whether or not those nationals are residents of the United States or the Czech Republic. For the purposes of U.S. tax, however, a U.S. national that is not a resident of the United States and a Czech national that is not a resident of the United States are not in the same circumstances, because only the U.S. national is subject to U.S. tax on its worldwide income.

The proposed treaty would adopt the OECD model treaty definition of nationals. Nationals would be individuals possessing the citizenship of the United States or the Czech Republic and all legal persons, partnerships, and associations deriving their status as such from the laws in force in the United States or the Czech Republic. Under the U.S. model treaty, by comparison, only U.S. citizens qualify as U.S. nationals for purposes of obtaining non-discrimination benefits.

Similarly, in general, a treaty country could not impose less favorable taxes on permanent establishments of enterprises of the other country than it imposes on its enterprises that carry on the same activities. However, a country would not be required to grant to residents of the other country the personal allowances, reliefs, or reductions for taxation purposes on account of civil status or family responsibilities that it grants to its own residents.

The proposed treaty makes clear that nothing in the article on non-discrimination is to be construed as preventing either country from imposing a branch profits tax.

Each country would be required (subject to the arm's-length pricing rules of Articles 9 (Associated Enterprises), 11(4) (Interest), and 12(5) (Royalties)) to allow an enterprise of a treaty country to deduct interest, royalties, and other disbursements paid by the enterprise to a resident of the other country under the same conditions that it allows deductions for such amounts paid to residents of the same country as the payor. Similarly, any debts of a resident of a treaty country to a resident of the other country, for purposes of determining the taxable capital of the first-mentioned resident, would be deductible under the same conditions as if the debts had been contracted to a resident of the first-mentioned country. The staff understands that this provision is not intended to limit in any way the ability of the United States to deny deductions for interest expense under the so-called "earnings-stripping" rules of section 163(j) of the Code.

The rules concerning non-discrimination also would apply to enterprises of one country which are owned in whole or in part by residents of the other country. An enterprise resident in one treaty country, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other country, could not be subject in the country of its residence to any taxation or any connected requirement which is other or more burdensome than the taxation and connected requirements that the

country of its residence imposes or may impose on other similar enterprises.

The saving clause would not apply to the provisions of the nondiscrimination article of the proposed treaty.

Article 26. Mutual Agreement Procedure

The proposed treaty contains a mutual agreement provision that would authorize the competent authorities of both the United States and the Czech Republic to consult together to attempt to alleviate individual cases of double taxation not in accordance with the proposed treaty. The saving clause of the proposed treaty would not apply to this article, so that the application of this article could result in waiver (otherwise mandated by a substantive provision of the proposed treaty) of taxing jurisdiction by the country of citizenship or residence.

Generally, under the proposed treaty, a person who considers that the actions of one or both of the treaty countries will cause that person to pay a tax not in accordance with the proposed treaty could present the case to the competent authority of the country of which the person is a resident or national. In such an instance, the case would have to be presented within three years from the first notification of the action resulting in taxation not in accordance with the provision of the proposed treaty. It would not be necessary for a person first to have exhausted the remedies provided under the internal laws of the two countries before taking the case to the competent authority.

Upon notification, the competent authority would make a determination as to whether the objection appears justified. If the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, then that competent authority would endeavor to resolve the case by mutual agreement with the competent authority of the other treaty country, with a view to the avoidance of taxation which is not in accordance with the Convention. The provision would require 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, would not authorize the imposition of additional taxes after the statute of limitations has run.

The competent authorities of the two countries would be required to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the treaty. They could also consult together for the elimination of double taxation in cases not provided for in the proposed treaty. According to the Technical Explanation, it is intended that the competent authorities could agree, for example, to the same attribution of income, deductions, credits, or allowances between a resident of a treaty country and its permanent establishment in the other country; to the allocation of income, deductions, credits, or allowances between persons; or to settle a variety of conflicting applications of the proposed treaty, including those regarding the characterization of items of income or of persons, the application of source rules to particular items of income, differences in meanings of a term, and differences in applying penalties, fines, and interest. Such agree-

ments would not have to conform to the internal law provisions of either treaty country.

The proposed treaty would authorize the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of the mutual agreement provisions. This provision makes clear that it would not be necessary to go through standard diplomatic channels in order to discuss problems arising in the application of the proposed treaty and also removes any doubt as to restrictions that might otherwise arise by reason of the confidentiality rules of the United States or the Czech Republic.

Article 27. Exchange of Information and Administrative Assistance

This article would form the basis for cooperation between the United States and the Czech Republic in their attempts to deal with avoidance or evasion of their respective taxes and to enable them to obtain information so that they could properly administer the proposed treaty. The proposed treaty would provide for the exchange of information which would be necessary to carry out its provisions or the provisions of the domestic laws of the two countries concerning taxes covered by it insofar as the taxation under those domestic laws would not be contrary to the proposed treaty. The exchange of information would not be restricted by Article 1 (General Scope). Therefore, the two countries could exchange information about third-country residents. The proposed treaty, like the U.S. model treaty, would provide for the exchange of information about all taxes imposed by either country (whether or not otherwise covered by the treaty).

Any information exchanged under these provisions would be treated as secret in the same manner as information obtained under the domestic laws of the country receiving the information. Exchanged information could be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the proposed treaty. Such persons or authorities could use the information for such purposes only, but could disclose the information in public court proceedings or in judicial decisions. The staff understands that this provision would permit access to taxpayer information to legislative bodies involved in the oversight of the administration of taxes, as well as to their agents. Persons involved in the administration of taxes include legislative bodies, such as, for example, the tax writing committees of Congress and the U.S. General Accounting Office.

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

Upon an appropriate request for information, the requested country would be required to obtain the information to which the request relates in the same manner and to the same extent as if its tax were at issue. Where specifically requested by the competent authority of a treaty country, the competent authority of the other country would provide the information in the form requested. Specifically, the requested competent authority would provide depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings) to the extent that they can be obtained under its laws and practices in the enforcement of its own tax laws.

Article 28. Diplomatic Agents and Consular Officers

The proposed treaty contains the rule found in other U.S. tax treaties that its provisions would not affect the fiscal privileges of diplomatic agents or consular officials under the general rules of international law or the provisions of special agreements. Accordingly, the proposed treaty would not defeat the exemption from tax which a host treaty country may grant to the salary of diplomatic officials of the other country.

The saving clause (as modified by paragraph 4(b) of Article 1) would not apply to this article, so that, for example, U.S. diplomats who are considered Czech residents would not be subject to Czech tax.

Article 29. Entry Into Force

The proposed treaty would be subject to ratification in accordance with the applicable procedures of the United States and the Czech Republic and the instruments of ratification would be exchanged as soon as possible in Washington, D.C. In general, the proposed treaty would enter into force when the instruments of ratification are exchanged.

With respect to taxes withheld at source (i.e., taxes on dividends, interest, and royalties), the treaty would be effective for amounts paid or credited on or after the first day of the second month next following the date on which the treaty enters into force. With respect to other taxes, the treaty would be effective for taxable periods beginning on or after January 1 *of the year in which* the treaty enters into force. This latter rule differs from the corresponding provision of the U.S. model treaty; under that provision, the treaty would be effective with respect to such other taxes for taxable periods beginning on or after the first day of January *next following the date on which* the treaty enters into force.

Article 30. Termination

The proposed treaty would continue in force indefinitely, but either country could terminate it at any time after five years from its entry into force. Notice of termination would have to be made through diplomatic channels, and given at least six months before the treaty could be terminated.

If termination occurs, it would be effective in respect of taxes withheld at source for amounts paid or credited on or after the first day of January next following the expiration of the notification period. With respect to other taxes, termination would occur with re-

spect to taxable periods beginning on or after the first day of January next following the expiration of the notification period.

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