[COMMITTEE PRINT]

PROPOSED INCOME TAX CONVENTION BETWEEN THE UNITED STATES AND ROMANIA

PREPARED FOR THE USE OF THE

COMMITTEE ON FOREIGN RELATIONS

BY THE STAFF OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

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INTRODUCTION

There is presently no income tax convention between the United States and Romania. Adoption of the proposed convention is desirable for a number of reasons. Over the years Romania has had extensive involvement in international commerce with the result that its tax system is relatively well developed with respect to the treatment of foreign investors. Also, it can be expected that there will be an increasing amount of economic as well as cultural contacts between the two countries which will generate an increasing amount of tax problems.

Due to the fact that Romanian tax authorities are familiar with the concept of income taxation used in the United States and Western Europe it was possible for the proposed convention to follow the model tax convention of the Organization for Economic Cooperation and Development (OECD) and the recent tax conventions of the United States (for example, the Japanese and Norwegian Conventions). Thus, the proposed convention with Romania, in general, follows the approach of other U.S. income tax treaties.

The most significant feature of the proposed convention is the adoption of the "effectively connected concept" in place of the so-called "force of attraction" doctrine which appeared in earlier treaties of the United States. Accordingly, a resident of one country who derives investment income from the other country will be entitled to the reduced rates of tax provided by the proposed convention even though he has a permanent establishment in the source country as long as the income is not effectively connected with the permanent establishment. This feature is embodied in The Foreign Investors Tax Act of 1966 and other recent U.S. tax treaties.

The other more important features of the proposed convention are the following:

(1) The United States and Romania are defined to include their respective continental shelves insofar as income arising from the exploration and exploitation of natural resources on the continental shelf is concerned. The effect of this provision is to recognize a country's jurisdiction to tax income arising in connection with natural resource activities on the country's continental shelf. A definition of this type is found in other recent income tax conventions (e.g., Belgium, Norway and Trinidad and Tobago). In addition, a similar provision was added to the Internal Revenue Code by the Tax Reform Act of 1969.

(2) The reciprocal exemption for income from ship and air transportation is extended to gains arising on the sale of the ships or aircraft and to income from the use of containers in connection with the use of a ship or aircraft.

(3) The tax on income from dividends is limited to a 10-percent rate.

(4) The tax on interest income is generally limited to a 10-percent rate with an exemption on interest paid in connection with indebtedness guaranteed, insured, or indirectly financed by one of the countries or an instrumentality thereof.

(5) The tax on income from cultural royalties (including films) is limited to a 10-percent rate and the tax on income from industrial royalties is limited to a 15-percent rate.

(6) Income from the equipment rentals are subject to tax only if effectively connected with a permanent establishment in the source country.

(7) Insurance or reinsurance premiums are not to be subject to any tax at the national level unless the premium is effectively connected with a permanent establishment which the recipient has in the source country.

GENERAL EXPLANATION

Article 1. Taxes covered

The proposed convention applies to the U.S. Federal income tax imposed under the Internal Revenue Code other than social security taxes. In the case of Romanian taxes it applies to the income taxes imposed under Romanian law; specifically, the Romanian income taxes imposed on wages, salaries, fees, copyrights, and income from any other source received by individuals, on the profits of mixed companies, or enterprises other than mixed companies or State enterprises, on agricultural activities, on rentals, and on nonresidents.

The proposed convention also contains a provision generally found in U.S. income tax treaties to the effect that it will apply to substantially similar taxes which either country may subsequently impose. In addition, for purposes of the provision of the proposed convention dealing with insurance and reinsurance provisions the proposed convention also applies to taxes other than income taxes imposed at the national level on premiums paid to a resident of the other country.

Additionally, it is provided that for purposes of the nondiscrimination provisions of the proposed convention (Article 22), the convention applies to all taxes imposed by the United States or Romania or political subdivisions or local governments thereof.

The two countries are to notify each other of amendments to the tax laws covered by the proposed convention and of the adoption of any taxes which subsequently are enacted and are so covered by the convention by transmitting the text of any amendments or new statutes at least once a year.

Article 2. General definitions

The standard definitions found in most of our income tax treaties are contained in the proposed convention.

In addition, the proposed convention contains a provision which is contained in the more recent U.S. tax treaties which includes within the definition of the term "United States" the territorial sea of the United States and the continental shelf of the United States insofar as the exploration and exploitation of natural resources on the continental shelf are concerned. This expanded definition, however, is applicable for purposes of the proposed convention only to the extent

that the person, property, or activity of concern is connected with the exploration and exploitation of natural resources. A similar definition of Romania is contained in the proposed convention. The definition of continental shelf areas contained in the proposed convention is similar to that contained in the conventions with Trinidad and Tobago, Belgium, and Norway and to that provided in the Internal Revenue Code (as amended by the Tax Reform Act of 1969) except that under the Code the continental shelf definitions apply only with respect to mines, oil and gas wells, and other natural deposits. Under the proposed convention, the applicability of the definition is not expressly restricted in this manner since it applies with respect to the exploration for or exploitation of any natural resource. In practical operation, however, the applicability of the provision usually will be similarly restricted. The activity of fishing is not intended to be considered the exploration or exploitation of natural resources of the continental shelf, and thus the definition of continental shelf is not to apply with respect to this activity.

The proposed convention also contains the standard provision that undefined terms are to have the meaning which they have under the applicable tax laws of the country applying the convention. It is further provided, however, that where a term is defined in a different manner by the two countries, the competent authorities of the two countries may establish a common meaning for the term in order to prevent double taxation or to further any other purpose of the convention.

Article 3. Fiscal domicile

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

Under the proposed convention, an individual whom both countries consider to be a resident according to their general rules for determining residence will be deemed for all purposes of the convention to be a resident of the country in which he has his permanent home, his center of vital interests, his habitual abode, or his citizenship. If the residence of an individual cannot be determined by these tests, applied in the order stated, the competent authorities of the countries will settle the question by mutual agreement.

Article 4. General rules of taxation

The proposed convention contains the basic general rules of taxation which are found in most of our other tax treaties. It provides that a resident of one country may be taxed by the other country only on income from sources within that other country (which includes under the source rules of the proposed convention, any business profits attributable to a permanent establishment of the resident in that other country). The proposed convention also provides that it is not to be interpreted as denying tax benefits available presently or in the future under the tax laws of the two countries or under any other agreement between the countries.

Additionally, the usual savings clause is contained in the proposed convention providing that with certain exceptions the proposed convention is not to affect the taxation by the United States or Romania of its citizens or residents. The principal exceptions involve the benefits provided under the foreign tax credit, the nondiscrimination, the governmental salaries, the teachers, and the students provisions.

Article 5. Definition of permanent establishment

The proposed convention contains a definition of "permanent establishment." The permanent establishment concept is one of the basic devices used in income tax treaties to avoid double taxation. Generally, a resident of one country is not taxable on its business profits by the other country unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the permanent establishment concept is used to determine whether the reduced rates of, or exemptions from, tax provided by the convention for dividends, interest, and royalties are applicable.

The proposed convention contains an expanded definition of permanent establishment which follows the pattern of the OECD model convention and other recent U.S. income tax treaties. In general, a fixed place of business through which a resident of one country engages in industrial or commercial activities in the other country is considered a permanent establishment. This includes a branch, an office, a factory, a workshop, a warehouse, and any building site, or construction or installation project which lasts for more than 12 months.

This general rule is modified to provide that a fixed place of business which is used for any or all of a number of specified activities will not constitute a permanent establishment. These activities include the use of facilities for storing, displaying, or delivering merchandise belonging to the resident, the maintenance of a stock of goods belonging to the resident for purposes of processing by another person, and the purchase of goods or collection of information for the resident.

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

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

The proposed convention provides that a resident of one country is not deemed to have a permanent establishment in the other country merely because the resident sells at the termination of a trade fair or convention in the other country goods or merchandise which were displayed by the resident at the trade fair or convention.

Article 6. Income from real property

The proposed convention provides that income from real property (not including interest on obligations secured by the property or secured by natural resource royalties) may be taxed in the country where the real property or natural resources are located. Income from real property includes income from the direct use, renting and gains on the sale, exchange or other disposition of the property.

Article 7. Business profits

Under the proposed convention, business profits of a resident of one country are taxable in the other country only to the extent they are attributable to a permanent establishment which the resident has in the other country. In computing the taxable business profits, the proposed convention allows the deduction of all expenses, wherever incurred, which are reasonably connected with the business profits.

It is further provided that business profits will not be attributed to a permanent establishment merely by reason of the purchase of merchandise by the permanent establishment, or by the resident of which it is a permanent establishment, for the account of that resident.

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

The proposed convention provides that insurance or reinsurance premiums derived by a resident of one country from sources within the other country are not to be subject to any income or other tax in the first country unless the income is effectively connected with a permanent establishment of that resident in the first country. The other taxes referred to in this provision include the stamp tax, imposed by section 4371 of the Internal Revenue Code on foreign insurance policies covering risks in the United States. Except for the inclusion of the exemption for the stamp tax, the results under this provision are the same as are reached in other income tax conventions of the United States.

The proposed convention sets forth examples of types of income which are considered business profits and in so doing follows the approach of our other recent treaties and the Internal Revenue Code by including within business profits investment income arising from a right or property which is effectively connected with the permanent establishment. The types of passive income included within business profits are income derived from real property and natural resources, dividends, interest, royalties and capital gains.

Article 8. Shipping and air transport

The proposed convention provides that income derived by a resident of one country from the operation in international traffic of ships or aircraft registered in that country (and gains from the sale or exchange of ships or aircraft used in international traffic which are registered in that country) are exempt from tax by the other country. Income from the operation in international traffic of ships or aircraft includes the rental income of ships or aircraft operated in international traffic if the rental income is incidental to income from the actual operation of ships or aircraft in international traffic. This rule permits for example an airline which is a resident of one country and which has excess equipment during certain periods to lease that excess equipment during those periods to an airline which is a resident of the other country. In such a case the rental income of the lessor is exempt from tax in the other country whether or not the other airline uses the aircraft in international traffic. The proposed convention also makes

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

Article 9. Related persons

The proposed convention and most other U.S. tax conventions contain a provision similar to section 482 of the Internal Revenue Code which allows the allocation of income in the case of transactions between related persons if an allocation is necessary to reflect the conditions and arrangements which would have been made between unrelated persons.

In addition the proposed convention recognizes the fact that when a redetermination has been made by one country wtih respect to the income of a related person the other country shall attempt to reach an agreement with the first country in connection with the redetermination and if it agrees with the redetermination it is to make a corresponding adjustment to the income of the other person.

Article 10. Dividends

Under the proposed convention, the rate of tax in the source country on dividends received by a resident of the other country is limited to 10 percent of the gross amount of the dividend unless the recipient has a permanent establishment in the other country and the shares with respect to which dividends are paid are effectively connected with that permanent establishment. If the shares are effectively connected with a permanent establishment then the dividends are to be taxed under the business article provisions of the proposed convention.

Article 11. Interest

Under the proposed convention, the rate of tax in the source country on interest derived by a resident of the other country is limited to 10 percent of the gross amount of the interest unless the recipient has a permanent establishment in the other country and the indebtedness giving rise to the interest is effectively connected with that permanent establishment. If the indebtedness is effectively connected with a permanent establishment the interest is to be taxed under the business profits article of the proposed convention.

Interest which is beneficially derived by one of the countries or by an instrumentality of that country is exempt from tax in the other country. Further, interest derived by a resident of one country with respect to indebtedness guaranteed, insured, or indirectly financed by that country or an instrumentality thereof is exempt from tax by the other country.

A definition of interest is contained in the proposed convention which is substantially identical to that found in the OECD model convention and other recent U.S. income tax treaties. It also contains a limitation on the application of the interest article which is found in these conventions, in situations where the payor and recipient are related, to the amount of interest which would have been paid had they not been related.

In addition, rules are provided for the source of interest income which are substantially identical to those found in other recent U.S. income tax treaties.

Article 12. Royalties

The proposed convention provides that royalties derived by residents of one country from sources in the other country may be taxed by the source country. However, a limitation is placed upon the amount of tax which may be collected by the source country. The source country may not impose a tax in excess of 10 percent of the gross amount in the case of cultural royalties and in excess of 15 percent of the gross amount in the case of industrial royalties.

Cultural royalties are defined as payments of any kind made as consideration for the use of, or the right to use, copyrights of literary, artistic, or scientific works, including copyrights of motion picture films, or tapes used for radio or television broadcasting. Industrial royalties are defined as payments of any kind made as consideration for the use of, or the right to use, patents, designs, models, plans, secret processes or formulae, trademarks, or other like property or rights, or for knowledge, experience, or skill (know-how). Cultural and industrial royalties include gains derived from the sale or exchange of any property or rights, to the extent that the amounts realized on the sale or exchange are contingent on the productivity, use, or disposition of the property or rights.

The proposed convention adopts the effectively connected concept. Accordingly, the reduced rate of tax for royalities is to apply unless the receipient has a permanent establishment in the source country and the royalties are effectively connected with that permanent establishment. This treatment generally follows that provided in the OECD model convention and other recent U.S. tax treaties.

In addition, as in the case of the interest provision, the royalty provision of the proposed convention does not apply to that part of a royalty paid to a related person which is considered excessive.

In the absence of a convention, royalties derived from the United States by Romanian residents are subject to a 30-percent tax. In the absence of a convention, cultural royalties derived from Romanian sources by non-residents are taxed at 20 percent of their gross amount and industrial royalties are taxed at 15 percent of their gross amount.

Article 13. Capital gains

The proposed convention generally provides that capital gains derived by a resident of one country will be exempt from tax by the other country unless the recipient of the gain has a permanent establishment in the other country and the property giving rise to the gain is effectively connected with the permanent establishment. In the case of an individual resident of one country, gains derived from the other country will be exempt from tax from that country unless the individual is present in that country for more than 183 days during the taxable year. This exemption from tax for capital gains does not apply with respect to gains derived from the sale or exchange of real property (or the sale or exchange of royalty interests when the amount realized on the sale or exchange is contingent on the productivity, use or disposition of the interest). The treatment of capital gains contained in the proposed convention is similar to the treatment provided in other recent U.S. tax conventions.

In the absence of a convention, the United States imposes a 30-percent tax on capital gains derived from the United States by non-

resident alien individuals who are present in this country for 183 days or more during the taxable year.

Article 14. Independent personal services

Under the proposed convention, income from the performance of independent personal services in one country (the source country) by a resident of the other country is exempt from tax in the source country unless the person performing the personal service (1) is present in the source country for 183 days or more during the taxable year, (2) maintains a permanent establishment in the source country with which the income is effectively connected, or (3) is an entertainer (such as a theater, motion picture, radio or television artist, musician, or an athlete). As a rule most U.S. tax treaties have a 183-day rule as part of the permanent establishment or fixed base provision.

If the individual is an entertainer the proposed convention provides that the income may be taxed by the source country if the entertainer is either present in that country for more than 90 day during the taxable year or if the income from the source country exceeds $3,000. However, the 90-day/$3,000 rule is not to apply to an entertainer who is present in the source country pursuant to a specific arrangement agreed to by the two countries. A specific arrangement need not name the individual performer as such if the performer is a member of a group that is clearly identified in the arrangement. However, a specific arrangement does not include cases where the performer's visit was merely encouraged by one or both countries. A specific arrangement is generally one which is agreed to by the two countries under the various cultural relations agreements which may be in effect between them.

Article 15. Dependent personal services

Under the proposed convention, income from services performed as an employee in one country (the source country) by a resident of the other country will not be taxable in the source country if three requirements are met: (1) the individual is present in the source country for less than 183 days during the taxable year; (2) the individual is an employee of a resident of his country of residence or of a permanent establishment maintained in his country of residence by a resident of the source country; and (3) the remuneration is not borne by a permanent establishment of the employer in the source country. In addition, the 90-day and $3,000 rule for entertainers performing independent personal services also applies to entertainers who are employees.

Remuneration derived by an individual from the performance of personal services as an employee aboard a ship or aircraft operated by a resident of one country in international traffic is exempt from tax by the other country if the individual is a member of the regular complement of the ship or aircraft.

Article 16. Private pensions, annuities, etc.

Under the proposed convention, private pensions and annuities derived from one country by residents of the other country are exempt from tax in the source country. In addition, alimony paid to a resident of one country is exempt from tax by the other country. Also, under the proposed convention a resident of one country who receives child

support payments from a resident of the other country is exempt from tax on these payments in both countries.

Article 17. Social security payments

Under the proposed convention, social security payments and other public pension payments (e.g., railroad retirement benefits) paid by one country to an individual who is a resident of the other country are exempt from tax in both countries. The more recent U.S. tax conventions have provided that only the country making the payment may tax the payment. However, the result is not changed under the proposed convention since the United States does not tax social security payments. Under the termination provisions of the proposed convention, the rules relating to social security payments may be terminated by either country at any time after the convention comes into force.

Article 18. Government functions

Under the proposed convention, wages including annuities or similar benefits paid from public funds of one country to a citizen of that country for labor or personal services performed as an employee of the national government of that country or any agency thereof in the discharge of governmental functions is exempt from tax by the other country. Labor or personal services are to be treated as performed in the discharge of governmental functions if the labor or services would be treated under the internal laws of both countries as so performed. The proposed convention generally follows the approach of other recent income tax conventions except that the exemption in the proposed convention is limited to individuals who are employees of the national government.

Article 19. Teachers

The proposed convention provides that a teacher or researcher who is a resident of one country will be exempt from tax in the other country on income from teaching in the host country if he is present in that country for a period not exceeding two years pursuant to an agreement between the countries or between educational institutions of the two countries or pursuant to an invitation of the host country or an educational institution of the host country. The exemption is not to apply if the research is undertaken not in the public interest but primarily for the private benefit of a specific person or persons.

Article 20. Students and trainees

Under the proposed convention, residents of one country who become students in the other country will be completely exempt from tax in the host country on gifts from abroad used for maintenance or study and on any grant, allowance or award received from a governmental or charitable organization. In addition, a limited exemption is provided for personal service income derived from sources within the country in which the individual is studying. Under this provision, the host country will exempt from tax $2,000 per year of personal service income (such as income from a part-time job). These exemptions (the complete, as well as the limited one) and the visiting teachers exemption may not be utilized for a period of more than 5 years in total.

In addition, the benefits under the teacher's article are not available to an individual if during the immediately preceding period an individual received the benefit of the student provision.

In addition to the exemption regarding students, the proposed convention follows the approach of other recent U.S. tax treaties and provides a limited exemption for personal service income of residents of one country who are employees of a resident of that country and who are temporarily present in the other country to study at an educational institution or acquire technical, professional or business experience. This exemption is available for a period of one year and is limited to $5,000. The proposed convention also provides an exemption for income from personal services performed in connection with training, research or study by residents of one country who are temporarily present in the other country as participants in Government sponsored exchange training programs. This exemption is limited to $10,000.

Article 21. Relief from double taxation

The proposed convention provides for the avoidance of double taxation by means of the foreign tax credit. Under the proposed convention, a U.S. citizen, resident, or corporation will be allowed a credit against the U.S. tax for the appropriate amount of income taxes paid to Romania. The credit allowed under this provision is subject to the provisions of a U.S. law applicable to the year in question and is limited to the amount of U.S. tax attributable to income from sources within Romania. Since this provision does not contain a specific formulation of the limitation on the credit allowed, a foreign tax credit claimed by a U.S. taxpayer under this provision of the proposed convention will be subject to the applicable limitation provided by the Internal Revenue Code.

For purposes of the foreign tax credit certain Romanian taxes will be considered to be income taxes. Among the taxes which will be considered creditable income taxes is the tax on enterprises other than mixed companies or State enterprises including the tax on foreign commercial representatives even though the tax applies to income imputed to the representative under a schedule based on the number of employees in the representatives' office and thus might not be creditable under section 901 of the code.

Under the proposed convention, Romania will provide a foreign tax credit to its citizens or residents in a manner parallel to the U.S. tax provision in the proposed convention.

Article 22. Nondiscrimination

The proposed convention contains a comprehensive nondiscrimination provision similar to provisions which have been embodied in other recent U.S. income tax treaties. It first provides that one country cannot discriminate by imposing more burdensome taxes on its residents who are citizens of the other country than it imposes on its own citizens who are also residents there.

Second, a citizen of one country who is a resident in the other country, or a permanent establishment which a resident of one country has in the other country, may not be subect in that other country to more burdensome taxes than are generally imposed in that other country on citizens or permanent establishments of residents of third countries carrying on the same activities. The comparison in the proposed convention is with respect to residents and businesses of third countries rather than citizens or residents of the contracting State

because the Romanian taxation of other foreign businesses is a more relevant comparison than Romanian taxation of domestic businesses which are frequently State-owned enterprises.

In addition, the proposed convention provides that a corporation of one country which is wholly or partly owned by one or more residents of the other country is not to be subjected in the first country to any taxation or requirement connected with taxation which is different or more burdensome than the taxation and requirements to which a corporation of the first country owned by residents of a third country is or may be subjected to. As with the provision prohibiting discrimination against permanent establishments the comparison for this provision is with residents of third countries. However, neither of these two provisions require a country to grant to residents and citizens of the other country tax benefits granted by special agreement to the residents and citizens of third countries which are granted by special agreement.

Articles 23, 24, and 26. Administrative provisions

The proposed convention contains various administrative provisions generally along the lines of the provisions contained in other U.S. tax treaties. In general, the proposed convention provides—

(1) for consultation and negotiation between the two countries to resolve differences arising in the application of the proposed convention and also to resolve claims by taxpayers that they are being subjected to taxation contrary to the terms of proposed convention;

(2) for the exchange between the countries of information pertinent to carrying out the provisions of the proposed convention or preventing fraud or fiscal evasion with respect to taxes covered by the proposed convention; and

(3) that each country assist the other in collecting taxes imposed by the other country to the extent necessary to insure that the benefits provided by the proposed convention are enjoyed only by persons entitled to those benefits.

Article 25. Diplomatic and consular officials

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

Article 27. Entry into force

The proposed convention will enter in force one month following the exchange of the instruments of ratification. It will become effective generally for taxable years (and payments made) beginning on or after January 1, 1974. Reductions in U.S. withholding taxes under the proposed convention generally will apply to amounts received on or after the date the proposed convention enters into force.

Article 28. Termination

The proposed convention will continue in force indefinitely but either country may terminate it at any time after 5 years from its entry into force by giving notice through diplomatic channels.

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