[JOINT COMMITTEE PRINT]

# EXPLANATION OF PROPOSED INCOME TAX TREATY BETWEEN THE UNITED STATES AND THE GRAND DUCHY OF LUXEMBOURG

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

ON OCTOBER 7, 1997

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PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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# INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, describes the proposed income tax treaty between the United States and the Grand Duchy of Luxembourg ("Luxembourg"). The proposed tax treaty was signed on April 3, 1996.[2] The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed tax treaty on October 7, 1997.

Part I of the pamphlet provides a summary with respect to the proposed tax treaty. Part II provides a brief overview of U.S. tax laws relating to international trade and investment and of U.S. income tax treaties in general. Part III contains an article-by-article explanation of the proposed tax treaty. Part IV is a discussion of issues with respect to the proposed tax treaty.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and the Grand Duchy of Luxembourg* (JCS–14–97), October 6, 1997.

[2] For a copy of the proposed tax treaty, see Senate Treaty Doc. 104–33, September 4, 1996.

# I. SUMMARY

The principal purposes of the proposed income tax treaty between the United States and Luxembourg 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 and investment caused by overlapping taxing jurisdictions of the two countries. It is intended to enable the two countries to cooperate in preventing avoidance and evasion of taxes.

As in other U.S. tax treaties, these objectives principally are achieved 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 contains provisions under which neither country generally will tax business income derived from sources within that country by residents of the other country unless the business activities in the taxing country are substantial enough to constitute a permanent establishment or fixed base (Articles 7 and 15). Similarly, the proposed treaty contains "commercial visitor" exemptions under which residents of one country performing personal services in the other country will not be required to pay tax in the other country unless their contact with the other country exceeds specified minimums (Articles 15, 16, and 18). The proposed treaty provides that dividends and certain capital gains derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles 10 and 14); however, the rate of tax that the source country may impose on a resident of the other country on dividends generally will be limited by the proposed treaty (Article 10). The proposed treaty also provides that interest and royalties derived by a resident of either country generally will be exempt from tax in the other country (Articles 12 and 13).

In situations where the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the proposed treaty generally provides for relief from the potential double taxation through the allowance by the country of residence of a tax credit for certain foreign taxes paid to the other country (Article 25).

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

The United States and Luxembourg have an income tax treaty currently in force (signed in 1962). The proposed treaty (as supplemented by the exchange of diplomatic notes) is similar to other recent U.S. income tax treaties, the 1996 U.S. model income tax treaty ("U.S. model"),[3] and the model income tax treaty of the Organization for Economic Cooperation and Development ("OECD model"). However, the proposed treaty contains certain substantive deviations from those documents.

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

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

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

### A. U.S. Tax Rules

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

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

U.S.-source fixed or determinable annual or periodical income of a nonresident alien individual or foreign corporation (including, for example, interest, dividends, rents, royalties, salaries, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to U.S. tax at a rate of 30 percent of the gross amount paid. Certain insurance premiums earned by a nonresident alien individual or foreign corporation are subject to U.S. tax at a rate of 1 or 4 percent of the premiums. These taxes generally are collected by means of withholding.

Specific statutory exemptions from the 30-percent withholding tax are provided. For example, certain original issue discount and certain interest on deposits with banks or savings institutions are exempt from the 30-percent withholding tax. An exemption also is provided for certain interest paid on portfolio debt obligations. In

addition, income of a foreign government or international organization from investments in U.S. securities is exempt from U.S. tax.

U.S.-source capital gains of a nonresident alien individual or a foreign corporation that are not effectively connected with a U.S. trade or business generally are exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien individual who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the disposition of interests in U.S. real property.

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

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

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

## B. U.S. Tax Treaties

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. Another related objective of U.S. tax treaties is the removal of the barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from,

that jurisdiction are minimal. To a large extent, the treaty provisions designed to carry out these objectives supplement U.S. tax law provisions having the same objectives; treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty partner.

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

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

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

The objective of preventing tax avoidance and evasion generally is accomplished in treaties by the agreement of each country to exchange tax-related information. Treaties generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information that is not obtainable under its laws or in the normal course of its administration

or that would reveal trade secrets or other information the disclosure of which would be contrary to public policy. The Internal Revenue Service (the "IRS"), and the treaty partner's tax authorities, also can request specific tax information from a treaty partner. This can include information to be used in a criminal investigation or prosecution.

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

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

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

## III. EXPLANATION OF PROPOSED TAX TREATY

A detailed, article-by-article explanation of the proposed income tax treaty between the United States and Luxembourg is presented below. The provisions set forth in the diplomatic notes (the "Notes") exchanged at the time the proposed treaty was signed are covered together with the relevant articles of the proposed treaty.[4]

### Article 1. General Scope

The general scope article describes the persons who may claim the benefits of the proposed treaty.

#### *Overview*

The proposed treaty generally applies to residents of the United States and to residents of Luxembourg, with modifications to such scope provided in other articles (e.g., Article 26 (Non-discrimination) and Article 28 (Exchange of Information)). As discussed below, the proposed treaty also contains a "saving clause" under which the United States generally remains free to tax its own residents and citizens without regard to the treaty.

The proposed treaty provides that it generally does not restrict any benefits accorded by internal law or by any other agreement between the United States and Luxembourg. Thus, the proposed treaty applies only where it benefits taxpayers. As discussed in the Treasury Department's Technical Explanation of the proposed treaty (hereinafter referred to as the "Technical Explanation"), the fact that the proposed treaty only applies to a taxpayer's benefit does not mean that a taxpayer 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 Luxembourg 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 generate effectively connected income as determined under the Internal Revenue Code (the "Code"), but that do not constitute permanent establishments as determined under the proposed treaty; one trade or business is profitable and the other generates 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

[4] The Notes state that the negotiators developed and agreed upon a common understanding and interpretation of certain provisions of the proposed treaty, intending to give guidance both to the taxpayers and the tax authorities of the two countries in interpreting various provisions contained in the proposed treaty.

could not invoke the proposed treaty to exclude the profits of the profitable trade or business that does not constitute a permanent establishment and invoke U.S. internal law to claim the loss of the unprofitable trade or business that does not constitute a permanent establishment against the taxable income of the permanent establishment.[5]

***Saving clause***

Like all U.S. income tax treaties, the proposed treaty is subject to a "saving clause." The saving clause in the proposed treaty is drafted unilaterally to apply only to the United States. Under this clause, with specific exceptions described below, the proposed treaty is not to affect the U.S. taxation of its residents or its citizens. By reason of this saving clause, unless otherwise specifically provided in the proposed treaty, the United States will continue to tax its citizens who are residents of Luxembourg as if the treaty were not in force. "Residents" for purposes of the proposed treaty (and, thus, for purposes of the saving clause) include corporations and other entities as well as individuals who are not treated as residents of the other country under the proposed treaty's tie-breaker provisions governing dual residents (as defined in Article 4 (Residence)).

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

[5] See Rev. Rul. 84–17, 1984–1 C.B. 308.

dents who otherwise would be subject to the special income tax rules contained in the Code.

Exceptions to the saving clause are provided for the following benefits conferred by the proposed treaty: correlative adjustments to the income of enterprises associated with other enterprises the profits of which were adjusted by Luxembourg (Article 9, paragraph 2); exemption from U.S. tax on pensions, social security benefits and annuities paid by Luxembourg (Article 19, paragraph 1(b)); relief from double taxation (Article 25); nondiscrimination (Article 26); and mutual agreement procedures (Article 27).

In addition, the saving clause does not apply to the following benefits conferred by the United States with respect to an individual who neither is a U.S. citizen nor has been admitted to the United States as a permanent resident. Under this rule, the specified treaty benefits are available to a Luxembourg citizen who spends enough time in the United States to be taxed as a U.S. resident under Code section 7701(b) (see discussion below in connection with Article 4 (Resident)), provided that the individual has not acquired U.S. immigrant status (i.e., is not a green-card holder). The benefits that are subject to this rule are exemption from tax on compensation from government service to Luxembourg (Article 20); exemption from U.S. tax on certain income received by temporary visitors who are students, trainees, teachers or researchers (Article 21); and certain fiscal privileges of diplomatic agents and consular officers referred to in the proposed treaty (Article 29).

The exceptions to the saving clause in the proposed treaty generally are consistent with the U.S. model and recent U.S. treaties. By contrast, although the double taxation provisions in paragraph 1(a) and (b) of Article XVI of the present treaty afford protection to citizens, residents and corporations with respect to tax imposed by their home country, the saving clause in paragraph 1(c) of Article XVI of the present treaty sets forth only two exceptions. The first exception applies to the governmental employment income derived by a resident of the other country (paragraph (1) of Article XI). The second exception applies to the nondiscrimination provisions of the treaty (paragraph (3) of Article XX). Under the present treaty, no exception to the saving clause is provided for the double taxation provisions.

***Coordination with dispute resolution procedures of other agreements***

The proposed treaty provides that its dispute resolution procedures under the mutual agreement article take precedence over the corresponding provisions of any other agreement between the United States and Luxembourg in determining whether a law or other measure is within the scope of the proposed treaty. Unless the competent authorities agree that the law or other measure is outside the scope of the proposed treaty, only the proposed treaty's nondiscrimination rules, and not the nondiscrimination rules of any other agreement in effect between the United States and Luxembourg, generally apply to that law or other measure. The only exception to this general rule is that the national treatment or most-favored nation treatment of the General Agreement on Tariffs and Trade will continue to apply with respect to trade in goods.

## Article 2. Taxes Covered

The proposed treaty generally applies to the income taxes of the United States and Luxembourg. It also applies to certain insurance excise taxes.

### *United States*

*In general*

In the case of the United States, the proposed treaty applies to the Federal income taxes imposed by the Code, but excludes social security taxes. Unlike many U.S. income tax treaties in force, but like the present treaty, the proposed treaty applies to the accumulated earnings tax and the personal holding company tax. In addition, as discussed below, the proposed treaty applies to the U.S. excise tax imposed on insurance premiums paid to foreign insurers; however, the proposed treaty does not apply to the U.S. excise tax imposed on reinsurance premiums paid to foreign insurers. The present treaty does not apply to any excise taxes. The proposed treaty does not apply to any U.S. State or local income taxes.

*Tax on insurance premiums*

*Code rules*—The United States imposes an excise tax on certain insurance and reinsurance premiums received by a foreign insurer from insuring a U.S. risk or a U.S. person (Code secs. 4371–4374). Unless waived by treaty, the excise tax applies to those premiums which are exempt from U.S. net-basis income tax. Under the Code, a foreign insurer is subject to U.S. net-basis income tax on income in situations where that insurance income is effectively connected with a U.S. trade or business. However, a foreign insurer ordinarily is not viewed as conducting a U.S. trade or business if it has no U.S. office or dependent agent and operates in the United States solely through independent brokers. In these situations, the insurance excise tax generally is imposed on the premiums paid for that insurance.[6]

The treatment of insurance income of foreign insurers is further complicated in situations where, as is often the case, some portion of the risk is reinsured with other insurers in order to spread the risk. In situations where the foreign insurer is engaged in a U.S. trade or business (and, thus, is subject to the U.S. income tax), reinsurance premiums, whether paid to a U.S. or foreign reinsurer, are allowed as deductions. Accordingly, the foreign insurer is taxable only on the income attributable to the portion of the risk it retains. However, while generally no excise tax is imposed on insurance policies issued by a foreign insurer doing business in the United States, the one-percent excise tax on reinsurance is imposed if the insurer reinsures that U.S. risk with a foreign insurer that is not subject to U.S. net-basis income tax.

*Proposed treaty*—The excise tax on insurance premiums is covered by the proposed treaty, but only to the extent that the foreign insurer does not reinsure the risks in question with a person not entitled to relief from this tax under an income tax treaty. How-

[6] The excise tax is currently imposed at a rate of 4 percent of the premiums paid on casualty insurance and indemnity bonds and 1 percent of the premiums paid on life, sickness, and accident insurance, annuity contracts, and reinsurance (Code secs. 4371–4374).

ever, in a departure from all existing U.S. tax treaties that cover the excise tax on insurance premiums, the excise tax on reinsurance premiums is not covered by the proposed treaty.

Under the proposed treaty, Luxembourg insurers generally are no longer subject to the insurance excise tax on insurance premiums. The insurance excise tax on insurance premiums continues to apply, however, when a Luxembourg insurer with no U.S. trade or business reinsures a policy it has written on a U.S. risk with a foreign reinsurer, other than another insurer entitled to a similar exemption under a different tax treaty (such as the U.S.-France treaty). In addition, the insurance excise tax on reinsurance premiums also continues to apply under the proposed treaty. This treatment is a departure from the present treaty.

***Luxembourg***

In the case of Luxembourg, the proposed treaty applies to the income tax on individuals, including the surcharge for the benefit of the employment fund (l'impôt sur le revenu des personnes physiques, y compris la contribution au fonds pour l'emploi). The proposed treaty also applies to the corporation tax, including the surcharge for the benefit of the employment fund (l'impôt sur le revenu des collectivités, y compris la contribution au fonds pour l'emploi); the tax on fees of directors of companies (l'impôt spécial sur les tantièmes); the capital tax (l'impôt sur la fortune); and the communal trade tax ((l'impôt commercial communal).

***Other rules***

For purposes of the nondiscrimination article (Article 26), the proposed treaty applies to taxes of all kinds imposed by the countries, including any taxes imposed by their political subdivisions or local authorities.

The proposed treaty also contains a provision generally found in U.S. income tax treaties (including the present treaty) to the effect that it applies to any identical or substantially similar taxes that either country may subsequently impose. The proposed treaty obligates the competent authority of each country to notify the competent authority of the other country of any significant changes in its internal tax laws and of any official published material concerning the application of the treaty, including explanations, regulations, rulings or judicial decisions. This clause is similar to the U.S. model.

**Article 3. General Definitions**

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

The term "Luxembourg" means the Grand Duchy of Luxembourg.

The term "United States" means the United States of America, but does not include Puerto Rico, the Virgin Islands, Guam or any other U.S. possession or territory.

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

An "enterprise of a Contracting State" is defined as an enterprise carried on by a resident of that country. The proposed treaty does not define the term "enterprise."

Under the proposed treaty, a person is considered a national of one of the treaty countries if the person is an individual possessing nationality or citizenship of that country or a legal person, partnership, or association deriving its status as such from the laws in force in that country.

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

The proposed treaty defines the term "beneficial owner" in the case of a company that is treated as a partnership, or other passthru entity, under the laws of the "other Contracting State" as the persons that are subject to tax on the income of such company under the laws of the "other Contracting State." The term "other Contracting State" is undefined. The Technical Explanation provides that the term "other Contracting State" refers to the residence country of the person claiming benefits under the proposed treaty. The proposed treaty uses the term "beneficial owner" in the following articles: Dividends (Article 10), Interest (Article 12), Other Income (Article 22), and Limitation on Benefits (Article 24) articles. The model treaties and other existing U.S. treaties do not contain a definition of a "beneficial owner."

The proposed treaty also contains the standard provision that, unless the context otherwise requires or the competent authorities of the two countries agree to a common meaning, all terms not defined in the proposed treaty are to have the meanings which they have under the laws of the country concerning the taxes to which the proposed treaty applies.

## Article 4. Residence

### *In general*

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

Under U.S. law, residence of an individual is important because a resident alien is taxed on worldwide income, while a nonresident alien is taxed only on certain U.S. source income and on income that is effectively connected with a U.S. trade or business. An individual who spends substantial time in the United States in any year or over a three-year period generally is treated as a U.S. resident (Code sec. 7701(b)). A permanent resident for immigration purposes (i.e., a green-card holder) also is treated as a U.S. resi-

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dent. The standards for determining residence provided in the Code 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.) Under the Code, a company is domestic, and therefore taxable on its worldwide income, if it is organized in the United States or under the laws of the United States, a State, or the District of Columbia.

The proposed treaty, like many recent U.S. tax treaties, generally defines "resident of a Contracting State" to mean any person who, under the laws of that country, is liable to tax therein by reason of his or her domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature. A U.S. citizen or a green-card holder who is not a resident of Luxembourg is treated as a U.S. resident under the proposed treaty only if the individual has a substantial presence, permanent home, or habitual abode in the United States.[7] Thus, citizenship alone does not establish residence. As a result, U.S. citizens residing overseas are not necessarily entitled to the benefits of the proposed treaty as U.S. residents. "Substantial presence" is a defined term under the Code definition of residence in section 7701(b); "permanent home" and "habitual abode" are terms frequently used in treaty "tie-breaker" rules, as described below.

The term "resident of a Contracting State" does not include any person who is liable to tax in that country in respect only of income from sources in that country or of capital situated in that country. In the case of income derived by a partnership, estate, or trust, the term applies only to the extent that the income it derives is subject to that country's tax as the income of a resident, either in its hands or in the hands of its partners, beneficiaries or grantors. For example, if the U.S. beneficiaries' share in the income of a U.S. trust is only one-half, Luxembourg would have to reduce its withholding tax pursuant to the proposed treaty on only one-half of Luxembourg source income paid to the trust.

For purposes of this rule, the government of a treaty country, or of one of its political subdivisions or local authorities, is to be considered to be a resident of that country. An organization that is a resident of a country under that country's internal law and is wholly or partially tax exempt because it is organized and operated exclusively (1) for a religious, charitable, educational, scientific, or other public purpose, or (2) to provide pensions or other benefits to employees pursuant to a plan is treated as a resident of a treaty country. The Technical Explanation provides that a pension that is also organized as a trust is subject to the rules for tax-exempt entities in determining the residence of a pension.

These provisions of the proposed treaty generally are based on the provisions of the U.S. and OECD models and are similar to the provisions found in other U.S. tax treaties.

[7] The present treaty does not define who is a U.S. resident. Thus, such a definition is determined under U.S. internal law. The Treasury Department has stated that a U.S. citizen is treated as a resident for purposes of the present treaty if the individual is taxed as a resident of the United States. Statement of Treasury Department Concerning Proposed Tax Convention Between The United States and The Grand Duchy Of Luxembourg With Respect To Taxes On Income and Property, as printed in Sen. Exec. Rep. No. 10, 88th Cong., 2d Sess. (1964). Consequently, a U.S. citizen who is resident in a country other than the United States may be treated as a U.S. resident, and hence, eligible for benefits under the present treaty.

### *Dual residents*

*Individuals*

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

*Entities*

In the case of an entity that is resident in both countries under the basic treaty definition, the proposed treaty requires the competent authorities to determine the residence of such person by mutual agreement, having regard to the entity's place of effective management, the place where it is incorporated or constituted, and any other relevant factors. If they are unable to reach such an agreement, the entity generally will be ineligible for benefits under the proposed treaty. In this regard, the proposed treaty is similar to some existing U.S. treaties, but dissimilar to the U.S. model, which does not specify that treaty benefits will be denied in cases where the competent authorities cannot agree. The Technical Explanation indicates that a dual resident corporation denied the benefits of the proposed treaty still may be treated as a resident of either country where its residence is relevant to benefits claimed by another person under the proposed treaty. For example, a Luxembourg resident may claim the benefits of reduced U.S. withholding tax on a dividend paid by a dual resident corporation.

## Article 5. Permanent Establishment

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

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

provided for dividends, interest, and royalties apply or whether those amounts are taxed as business profits.

In general, under the proposed treaty, a permanent establishment is a fixed place of business through which an enterprise engages in business. A permanent establishment includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources. It also includes any building site or construction or installation project, or an installation or drilling rig or ship used for the exploration of natural resources, if the site or project lasts for more than 12 months. The Technical Explanation provides that projects that are commercially and geographically interdependent are to be treated as a single project for purposes of the 12-month test. The 12-month period for establishing a permanent establishment in connection with a site or project corresponds to the rule of the U.S. model. The present treaty provides that a permanent establishment exists if the site or project lasts for more than six months.

The general definition of a permanent establishment is modified to provide that a fixed place of business that is used for any of a number of specified activities does not constitute a permanent establishment. These activities include the use of facilities solely for storing, displaying, or delivering merchandise belonging to the enterprise and the maintenance of a stock of goods 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 merchandise or the collection of information for the enterprise. These activities include as well the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character. Unlike the present treaty, the proposed treaty makes no reference to such activities as advertising, the supply of information, or scientific research. However, the Technical Explanation mentions advertising and the supply of information as activities that are preparatory or auxiliary. The proposed treaty, like the U.S. model, provides that the maintenance of a fixed place of business solely for any combination of these activities does not constitute a permanent establishment. This clause does not appear in the present treaty.

If a person, other than an independent agent, is acting on behalf of an enterprise and has and habitually exercises the authority to conclude contracts in a country on behalf of an enterprise of the other country, the enterprise generally will be deemed to have a permanent establishment in the first country in respect of any activities that person undertakes for the enterprise. Consistent with the U.S. model and the OECD model, this rule does not apply where the contracting authority is limited to those activities described above, such as storage, display, or delivery of merchandise, which are excluded from the definition of permanent establishment. Under the present treaty, where an agent's authority is limited to the purchase of merchandise for the account of the enterprise, such enterprise is not considered to have a permanent establishment.

The proposed treaty contains the usual provision that no permanent establishment is deemed to arise based on an agent's activities if the agent is a broker, general commission agent, or any other agent of independent status acting in the ordinary course of its business. The Technical Explanation provides that an independent agent is one that is legally and economically independent of the enterprise. Whether an agent and an enterprise are independent depends on the facts and circumstances of the particular case.

The fact that a company that is resident in one country 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 does not of itself cause either company to be a permanent establishment of the other.

**Article 6. Income from Real Property (Immovable Property)**

This article covers income, but not gains, from real property. The rules covering gains from the sale of real property are contained in Article 14 (Gains).

Under the proposed treaty, income derived by a resident of one country from real property situated in the other country may be taxed in the country where the real property is located. Income from real property includes income from agriculture or forestry. The term "real property" generally has the meaning that it has under the law of the country in which the property in question is situated.[8]

The proposed treaty specifies that the country in which property is situated may tax income derived from the direct use, letting, or use in any other form of such real property. The rules of this article allowing source country taxation also apply to income from real property of an enterprise and to income from real property used for the performance of independent personal services.

The present treaty permits the source country to tax interest on debts (other than bonds) secured by mortgages on real property under this article. The proposed treaty eliminates this rule and treats such interest in the same manner as other types of interest, which generally is free from source country tax (see Article 12).

Like the U.S. model and certain other U.S. income tax treaties, the proposed treaty provides residents of a country with an election to be taxed on a net basis by the other country on income from real property in that other country. The Technical Explanation provides that the election may be terminated with the consent of the competent authority of the country where the real property is located. U.S. internal law provides such a net-basis election in the case of income derived by a foreign person from U.S. real property (Code secs. 871(d) and 882(d)).

**Article 7. Business Profits**

***U.S. internal law***

U.S. law distinguishes between the U.S. business income and other U.S. income of a nonresident alien or foreign corporation. A nonresident alien or foreign corporation is subject to a flat 30-per-

[8] In the case of the United States, the term "real property" is defined in Treas. Reg. sec. 1.897–1(b).

cent rate (or lower treaty rate) of tax on certain U.S. source income if that income is not effectively connected with the conduct of a trade or business within the United States. The regular individual or corporate rates apply to income (from any source) which is effectively connected with the conduct of a trade or business within the United States.

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

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

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

***Proposed treaty limitations on internal law***

Under the proposed treaty, business profits of an enterprise of one country are taxable in the other country only to the extent that they are attributable to a permanent establishment in the other country through which the enterprise carries on business.

The taxation of business profits under the proposed treaty differs from U.S. rules for taxing business profits primarily by requiring more than merely being engaged in a trade or business before a country can tax business profits and by substituting an "attributable to" standard for the Code's "effectively connected" standard.

Under the Code, 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.

The present treaty contains a force of attraction rule similar to that in the Code as described above. The proposed treaty eliminates this rule, providing instead that the business profits to be attributed to the permanent establishment shall include only the profits derived from the assets or activities of the permanent establishment. The proposed treaty is consistent with the U.S. model and other existing U.S. treaties in this respect.

The business profits of a permanent establishment are determined on an arm's-length basis. Thus, there are to be attributed to a permanent establishment the business profits which would be expected to have been derived by it if it were a distinct and separate entity engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment. For example, this arm's-length rule applies to transactions between the permanent establishment and a branch of the resident enterprise located in a third country. Amounts may be attributed to the permanent establishment whether they are from sources within or without the country in which the permanent establishment is located.

In computing taxable business profits, the proposed treaty provides that deductions are allowed for expenses incurred for the purposes of the permanent establishment. These deductions include a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole (or, if not the enterprise as a whole, at least the part of the enterprise that includes the permanent establishment). According to the Technical Explanation, under this language, the United States is free to use its current expense allocation rules, including the rules for allocating deductible interest expense under Treas. Reg. sec. 1.882–5, in determining deductible amounts. Thus, for example, a Luxembourg company which has a branch office in the United States but which has its head office in Luxembourg will, in computing the U.S. tax liability of the branch, be entitled to deduct a portion of the executive and general administrative expenses incurred in Luxembourg by the head office for purposes of operating the U.S. branch, allocated and apportioned in accordance with Treas. Reg. sec. 1.861–8.

Business profits are not attributed to a permanent establishment merely by reason of the purchase of merchandise by a permanent establishment for 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 are not increased by the profit element with respect to its purchasing activities.

The amount of profits attributable to a permanent establishment must be determined by the same method each year unless there is good and sufficient reason to change the method. Where business profits include items of income which are dealt with separately in other articles of the proposed treaty, those other articles, and not the business profits article, govern the treatment of such items of

income. Thus, for example, profits attributable to a U.S. ticket office of a Luxembourg airline are generally exempt from U.S. Federal income tax under the provisions of Article 8 (Shipping and Air Transport).

Like the present Luxembourg treaty, but unlike the U.S. model, the proposed treaty contains no definition of "business profits." Under the U.S. model, the term means income derived from any trade or business, including income derived by an enterprise from the performance of personal services, and from the rental of tangible personal property. The Technical Explanation provides that it is understood that under the proposed treaty the term "business profits" includes income from the performance of personal services by an enterprise and income from the rental of tangible personal property. Income from the rental or licensing of cinematographic films is treated as royalties under the present and the proposed treaty.

The proposed treaty incorporates the rule of Code section 864(c)(6) and provides that any income or gain attributable to a permanent establishment or a fixed base during its existence is taxable in the country where the permanent establishment or fixed base is located even though payments are deferred until after the permanent establishment or fixed base has ceased to exist. This rule applies with respect to business profits (Article 7, paragraphs 1 and 2), dividends (Article 10, paragraph 4), interest (Article 12, paragraph 3), royalties (Article 13, paragraph 3), capital gains (Article 14, paragraph 3), independent personal services income (Article 15) and other income (Article 22, paragraph 2).

**Article 8. Shipping and Air Transport**

Article 8 of the proposed treaty covers income from the operation of ships and aircraft in international traffic. The rules governing income from the sale of ships and aircraft operated in international traffic are contained in Article 14 (Gains).

Under the Code, the United States generally taxes the U.S. source income of a foreign person from the operation of ships or aircraft to or from the United States. An exemption from U.S. tax is provided if the income is earned by a corporation that is organized in, or an alien individual who is resident in, a foreign country that grants an equivalent exemption to U.S. corporations and residents. The United States has entered into agreements with a number of countries, including Luxembourg, providing such reciprocal exemptions. Benefits accorded under such an agreement are not restricted by the proposed treaty.

Under the proposed treaty, profits which are derived by an enterprise of one country from the operation in international traffic of ships or aircraft ("shipping profits") are taxable only in that country, regardless of the existence of a permanent establishment in the other country. "International traffic" means any transport by a ship or aircraft except when such transport is operated solely between places in a treaty country (Article 3(1)(d) (General Definitions)). Unlike the exemption provided in the present treaty, the exemption in the proposed treaty applies whether or not the ships or aircraft are registered in the first country.

For purposes of the proposed treaty, shipping profits include income from the rental of ships or aircraft on a full basis. Shipping profits also include profits from bareboat leases of ships or aircraft if such ships or aircraft are operated in international traffic by the lessee or if the rental income is incidental to profits from the operation of ships or aircraft in international traffic. Thus, the exemption from source country tax for shipping profits applies to 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 for use in international traffic. In addition, profits derived by an enterprise from the inland transport of property or passengers within a country are treated as shipping profits eligible for exemption if such transport is undertaken as part of international traffic by the enterprise. These rules are similar to the rules in the U.S. model.

Like the U.S. model, the proposed treaty provides that income derived by an enterprise of one country from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) used in international traffic is taxable only in that country.

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

**Article 9. Associated Enterprises**

The proposed treaty, like most other U.S. tax treaties, contains an arm's length pricing provision. The proposed treaty recognizes the right of each country to determine the profits taxable by that country in the case of transactions between related enterprises, if the profits of an enterprise do not reflect the conditions which would have been made between independent enterprises.

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

Like the present Luxembourg treaty and the U.S. and OECD models, the proposed treaty does not include the paragraph contained in many other U.S. tax treaties which provides that the rights of the treaty countries to apply internal law provisions relating to adjustments between related parties are fully preserved. Nevertheless, the Technical Explanation provides that it is understood that the respective countries will apply their internal intercompany pricing rules (e.g., Code sec. 482, in the case of the United States). The Technical Explanation also clarifies that the U.S. "commensurate with income" standard for finding appropriate transfer prices for intangibles does not represent a departure in U.S. practice or policy from the arm's-length standard.

When a redetermination of tax liability has been properly made by one country, the other country will make an appropriate adjustment to the amount of tax charged in that country on the redeter-

mined income. This "correlative adjustment" clause has no counterpart in the present treaty. In making that adjustment, due regard is to be given to other provisions of the treaty, and the competent authorities of the two countries will consult with each other if necessary. For example, under the mutual agreement article (Article 27), a correlative adjustment cannot necessarily be denied on the ground that the time period set by internal law for claiming a refund has expired. To avoid double taxation, the proposed treaty's saving clause retaining full taxing jurisdiction in the country of residence or nationality (discussed above in connection with Article 1 (General Scope)) does not apply in the case of such adjustments.

## Article 10. Dividends

### *Overview*

The proposed treaty replaces the dividend article of the present treaty with a new article that makes several changes. First, the proposed treaty generally liberalizes the conditions under which the 5-percent direct dividend withholding rate limitation is imposed. Second, the proposed treaty permits exceptions to the general 5-percent and 15-percent source country tax rates on dividends from a regulated investment company ("RIC") or a real estate investment trust ("REIT"). Third, the proposed treaty permits the application by the source country of the treaty's dividend tax rates to income from arrangements, including debt obligations, carrying the right to participate in profits.

### *Internal dividend taxation rules*

*United States*

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

Under U.S. law, the term dividend generally means any distribution of property made by a corporation to its shareholders, either from accumulated earnings and profits or current earnings and profits. However, liquidating distributions generally are treated as payments in exchange for stock and thus are not subject to the 30-percent withholding tax described above (see discussion of capital gains in connection with Article 14 below).

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

In general, corporations are not entitled under U.S. law to a deduction for dividends paid. Thus, the withholding tax on dividends

theoretically represents imposition of a second level of tax on corporate taxable income. Treaty reductions of this tax reflect the view that where the United States already imposes corporate level tax on the earnings of a U.S. corporation, a 30-percent withholding rate may represent an excessive level of source country taxation. Moreover, the reduced rate of tax often applied by treaty to dividends paid to direct investors reflects the view that the source country tax on payments of profits to a substantial foreign corporate shareholder may properly be reduced further to avoid double corporate-level taxation and to facilitate international investment.

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

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

U.S. internal law also generally treats a RIC as both a corporation and a conduit for income tax purposes. The purpose of a RIC is to allow investors to hold a diversified portfolio of securities. Thus, the holder of stock in a RIC may be characterized as a portfolio investor in the stock held by the RIC, regardless of the proportion of the RIC's stock owned by the dividend recipient.

*Luxembourg*

Luxembourg generally imposes a 25-percent withholding tax on certain Luxembourg-source dividend payments, including distributions from profit-sharing bonds and certain liquidation proceeds.[9] The dividend tax generally applies to Luxembourg-source proceeds, whether paid to individual or corporate residents or nonresidents.[10] The dividend tax does not apply to a dividend paid to a foreign corporation residing in a European Union ("EU") member country, if the dividend is subject to Luxembourg tax law provisions enacted in response to the so-called "parent-subsidiary directive" approved

[9] Under U.S. law, by contrast, liquidation proceeds generally are treated as capital gains, and are thus not subject to the corresponding U.S. 30-percent withholding tax. The Luxembourg dividend tax, therefore, may apply to Luxembourg-source income paid to a U.S. resident in a case where a corresponding U.S.-source item of income paid to a Luxembourg resident might not be subject to U.S. withholding tax under the Code.

[10] An exemption applies to certain dividends paid to Luxembourg corporations holding at least 10 percent of the stock of the payor. This exemption mirrors the so-called "participation exemption" under which Luxembourg corporations are exempt from tax on dividends paid by corporations (Luxembourg or foreign) in which the recipient owns at least a 10-percent interest.

by the EU Council of Ministers on July 23, 1990.[11] Moreover, the dividend tax does not apply (or applies at a reduced rate) to an amount paid to a nonresident eligible for the elimination or reduction of the dividend tax by treaty.

The dividend tax is creditable against the Luxembourg income or company tax imposed on a Luxembourg resident shareholder receiving the taxable amount (or, in some cases, a nonresident shareholder that is subject to Luxembourg income or corporate tax). An excess of the dividend tax over those taxes generally is refundable.

Like U.S. corporate tax law, Luxembourg tax law generally embodies the so-called "classical system" under which corporate income may be taxed at the corporate level, and then taxed again at the shareholder level upon a distribution, without a mechanism such as an imputation credit or a dividends paid deduction to integrate the two levels of tax. Since 1994, Luxembourg permits a 50-percent dividend received deduction for dividends paid by Luxembourg companies to a Luxembourg resident shareholder or to a permanent establishment of a nonresident shareholder.

### ***Proposed treaty limitations on internal law***

*Reduction of withholding tax*

Under the present treaty, the source country dividend withholding tax generally may not exceed a 15-percent rate. However, because the present treaty limits the rate of withholding on dividends to half of the statutory rate in effect *at the time the treaty went into force,* the Luxembourg withholding tax is actually imposed at 7.5 percent for dividends paid to U.S. persons. On the other hand, portfolio dividends paid by a U.S. person to a Luxembourg recipient are subject to a 15-percent withholding tax. Under the present treaty, a 5-percent rate applies if a higher ownership threshold is met. Such threshold is met if 50 percent of the stock of the payor corporation is owned either by a corporate recipient residing in the other country or by a group of four (or fewer) corporations resident in the other country each of which is at least a 10-percent shareholder; the ownership test must be met for the period beginning at the start of the paying corporation's previous taxable year and ending on the date the dividend is paid.

Under the proposed treaty, dividends paid by a company that is resident of a country to a resident of the other country may be taxed in the source country. However, source country taxation is limited to 5 percent of the gross amount of the dividends if the beneficial owner of the dividends is a company which holds directly at least 10 percent of the voting stock of the payor company. The source country dividend withholding tax generally is limited to 15 percent of the gross amount of the dividends in all other cases.

The proposed treaty eliminates Luxembourg withholding tax in the case of dividends paid by a Luxembourg company if the beneficial owner of the dividend is a U.S. company that meets certain ownership requirements. In order to meet the ownership requirements, the U.S. company must own directly at least 25 percent of the voting stock of the Luxembourg payor for an uninterrupted period of two years preceding the date of payment of the dividends.

[11] 90/435/EEC.

In addition, the dividend must be derived from the active conduct of a trade or business by the payor in Luxembourg (other than the business of making or managing investments, unless the payor is a banking or insurance company). The Technical Explanation provides that dividends paid out of profits generated in a subsidiary or branch outside of Luxembourg will not qualify for the exemption. If the U.S. recipient has different holding periods for the stock of the Luxembourg payor, the proposed treaty provides that the Luxembourg withholding tax is eliminated only with respect to the dividends attributable to that part of the share holding that satisfies such ownership requirements.

Under the present treaty, the prohibition on source country tax at a rate exceeding 5 percent does not apply in certain cases where more than 25 percent of the gross income of the dividend payor for the prior taxable year consisted of interest and dividends. The proposed treaty eliminates this rule, and replaces it with rules similar to those adopted in recent treaties that allow source country tax in excess of 5 percent on direct investment dividends from a RIC or REIT.[12]

The proposed treaty allows the United States to impose a 15-percent tax on a U.S. source dividend paid by a RIC to a Luxembourg company owning 10 percent or more of the voting shares of the RIC. The proposed treaty allows the United States to impose a 15-percent tax on a U.S.-source dividend paid by a REIT to an individual owning less than 10 percent of the REIT. There is no limitation in the proposed treaty on the tax that may be imposed by the United States on a REIT dividend that is beneficially owned by a Luxembourg resident, if the beneficial owner of the dividend is either an individual holding a 10 percent or greater interest in the REIT or is not an individual. Thus, such a dividend is taxable at the 30-percent United States statutory rate.

*Definition of dividends*

Unlike the U.S. model and the OECD model, the present treaty provides no express definition of the term dividend. The proposed treaty provides a definition of dividends that is broader than the definition in the U.S. model and some other recent U.S. treaties. The proposed treaty generally defines "dividends" as income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares, or other rights, not being debt-claims participating in profits. Dividends also include income treated as a distribution by the taxation law of the country in which the distributing company is resident. The proposed treaty provides that a beneficial owner of dividends who holds depository receipts evidencing ownership of the shares in lieu of the shares themselves also is entitled to the reduced dividend withholding rates. The proposed treaty also provides that the term dividends includes income from arrangements, including debt obligations, carrying the right to participate in, or determined with reference to, profits of the issuer or one of its associated enterprises, to the extent such income is character-

[12] The Technical Explanation indicates that distributions by a REIT that are attributable to gains from the disposition of a U.S. real property interest are not treated as dividends under the proposed treaty. Such distributions are covered by the provisions of Article 14 (Gains).

ized as a dividend under the law of the country in which the income arises.

*Special rules and exceptions*

The proposed treaty's reduced rates of tax on dividends do not apply if the beneficial owner of the dividend carries on business through a permanent establishment (or a fixed base, in the case of an individual who performs independent personal services) in the source country and the dividends are attributable to the permanent establishment (or fixed base). Such dividends are taxed as business profits (Article 7) or as income from the performance of independent personal services (Article 15). In addition, dividends attributable to a permanent establishment or fixed base, but received after the permanent establishment or fixed base is no longer in existence are taxable in the country where the permanent establishment or fixed base existed (Article 7, paragraph 7).

The proposed treaty contains a general limitation on the taxation by one country of dividends paid by companies that are residents of the other country. Under this provision, the United States may not, except in two cases, impose any taxes on dividends paid by a Luxembourg resident company that derives profits or income from the United States. The first exception is the case where the dividends are paid to U.S. residents. The second exception is the case where the holding in respect of which the dividends are paid forms part of the business property of a U.S. permanent establishment or pertains to a fixed base in the United States. This rule is somewhat less restrictive of the United States' taxing jurisdiction than the corresponding rule in the present treaty. The present treaty provides that dividends paid by a Luxembourg corporation are exempt from U.S. tax in any case where the recipient is not a U.S. citizen, resident, or corporation.

Finally, the dividend article of the proposed treaty prohibits any tax by one treaty country on the undistributed profits of a company resident in the other treaty country, except as provided in the branch tax article (Article 11).

### Article 11. Branch Tax

The proposed treaty expressly permits the United States to collect the branch profits tax from a Luxembourg company. Luxembourg does not impose a branch profits tax.

#### *U.S. branch profits tax rules*

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," which is a measure of the accumulated U.S. effectively connected earnings of the corporation that are removed in any year from its U.S. trade or business. The dividend equivalent amount is limited by (among other things) aggregate earnings and profits accumulated in taxable years beginning after December 31, 1986. The Code provides that no U.S. treaty shall exempt any foreign corporation from the branch profits tax (or reduce the amount thereof) unless the foreign corporation is a "qualified resident" of the treaty country. The definition of a "qualified resident" under U.S. internal law is somewhat

similar to the definition of a corporation eligible for benefits under the proposed treaty (discussed below in connection with Article 24 (Limitation on Benefits)).

#### *Proposed treaty limitations on internal law*

The proposed treaty allows the United States to impose the branch profits tax on a Luxembourg resident 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 real property interests. Like the U.S. model, the proposed treaty permits at most a 5-percent branch profits tax rate, and, in cases where a foreign corporation conducts a trade or business in the United States, but not through a permanent establishment, the proposed treaty would generally eliminate the branch profits tax that the Code imposes on such corporation.

In general, the proposed treaty provides that the branch profits tax may be imposed by the United States only on the business profits of the foreign corporation that are attributable to its U.S. permanent establishment or that are subject to tax on a net basis as income or gains from real property. The proposed treaty and the Notes permit the United States to impose its branch profits tax on the "dividend equivalent amount" as that term is defined under the Code and as it may be amended from time to time without changing the general principle thereof.

None of the restrictions on the operation of U.S. branch tax provisions apply, however, unless the corporation seeking treaty protection meets the conditions of the proposed treaty's limitation on benefits article (Article 24). As discussed below, the limitation on benefits requirements of the proposed treaty are similar in some respects to the analogous provisions of the branch profits tax provisions of the Code.

### Article 12. Interest

#### *U.S. internal law*

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

Portfolio interest generally is defined as any U.S. source interest that is not effectively connected with the conduct of a trade or busi-

ness and that (1) is paid on an obligation that satisfies certain registration requirements or specified exceptions thereto, and (2) is not received by a 10-percent owner of the issuer of the obligation, taking into account shares owned by attribution. However, the portfolio interest exemption is inapplicable to certain contingent interest income.

If an investor holds an interest in a fixed pool of real estate mortgages that is a real estate mortgage interest conduit ("REMIC"), the REMIC is treated generally for U.S. tax purposes as a pass-through entity and the investor is subject to U.S. tax on a portion of the REMIC's income (which 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 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.

***Luxembourg internal law***

Luxembourg generally does not impose tax on interest income of nonresidents, unless the interest income is earned in connection with a Luxembourg permanent establishment. However, Luxembourg imposes a 25-percent withholding tax on interest from profit-sharing bonds. In addition, a nonresident may be subject to Luxembourg tax on interest on loans secured by real property situated in Luxembourg.

***Proposed treaty limitations on internal law***

*Elimination of withholding tax*

The proposed treaty generally exempts from the U.S. 30-percent tax interest (within the proposed treaty definition of that term) paid to Luxembourg residents. The proposed treaty also exempts from Luxembourg taxes, in those few cases where any such tax might otherwise be applicable, Luxembourg-source interest paid to U.S. residents. These reciprocal exemptions are similar to those in effect under the present treaty and in the U.S. model. The staff understands that the proposed treaty also exempts Luxembourg corporations from the U.S. branch level excess interest tax.

The exemptions apply only if the interest is beneficially owned by a resident of one of the countries. Accordingly, they do not apply if the recipient of the interest is a nominee for a nonresident.

No such exemption applies to an excess inclusion with respect to a residual interest in a REMIC. Thus, such inclusions may be taxed by the United States at 30 percent under the proposed treaty.

In addition, the exemptions do not apply if the beneficial owner of the interest carries on business through a permanent establishment (or a fixed base, in the case of an individual who performs independent personal services) in the source country and the inter-

est paid is attributable to the permanent establishment (or fixed base). In that event, the interest is taxed as business profits (Article 7) or income from the performance of independent personal services (Article 15). In addition, interest attributable to a permanent establishment or fixed base, but received after the permanent establishment or fixed base is no longer in existence, is taxable in the country where the permanent establishment or fixed base existed (Article 7, paragraph 7).

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

Unlike the present treaty, the proposed treaty allows the source country to impose a tax, at a rate not exceeding 15 percent, on the interest arising from that country and determined with reference to the profits of the issuer or of one of its associated enterprises. Thus, the proposed treaty permits the United States to tax, at a 15-percent rate, the amount of U.S.-source contingent interest derived by a Luxembourg resident. The treaty also permits Luxembourg to tax, at the same rate, the amount of Luxembourg-source interest from profit-sharing bonds derived by a U.S. resident.

*Definition of interest and source rules*

The proposed treaty defines interest generally as income from debt claims of every kind, whether or not secured by mortgage, and whether or not carrying a right to participate in the debtor's profits (unless described in the dividends article (Article 10)). In particular, it includes income from government securities and from bonds or debentures, including premiums or prizes attaching to such securities, bonds, or debentures. The proposed treaty also defines interest to include all other income that is treated as income from money lent by the taxation law of the source country. Penalty charges for late payment are not treated as interest.

In general, under the proposed treaty, interest is deemed to arise in the residence country of the payor. However, if the payor (whether or not a resident of the United States or Luxembourg) has a permanent establishment or a fixed base in one of the treaty countries, the debt on which the interest is paid was incurred in connection with that permanent establishment or fixed base and the interest is borne by the permanent establishment or fixed base, the interest is deemed to arise in the country in which the permanent establishment or fixed base is located. For example, interest paid to a Luxembourg resident by the U.S. branch of a French company is considered U.S.-source under the proposed treaty and, therefore, is exempt from U.S. tax.

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## Article 13. Royalties

### *Internal law*

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 and on gains from the disposition of certain intangible property to the extent that such gains are from payments contingent on the productivity, use, or disposition of the intangible property. 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. Luxembourg generally imposes a 10- or 12-percent tax on royalties derived by nonresidents.

### *Proposed treaty limitations on internal law*

The proposed treaty provides that royalties arising in one treaty country and paid to a resident of the other country may be taxed only by the residence country. Thus, the proposed treaty generally continues the rule of the present treaty that exempts U.S.-source royalties paid to Luxembourg residents from the 30-percent U.S. tax. This exemption is similar to that provided in the U.S. model. The exemption applies only if the royalty is beneficially owned by a resident of the other country; it does not apply if the recipient of the royalty is a nominee for a nonresident.

The exemption under the proposed treaty does not apply where the beneficial owner carries on business through a permanent establishment (or a fixed base, in the case of an individual who performs or performed independent personal services) in the source country and the royalties are attributable to the permanent establishment (or fixed base). In that event, such royalties are taxed as business profits (Article 7) or income from the performance of independent personal services (Article 15). In addition, royalties attributable to a permanent establishment or fixed base, but received after the permanent establishment or fixed base is no longer in existence, are taxable in the country where the permanent establishment or fixed base existed (Article 7, paragraph 7).

Similar to the U.S. model and the OECD model, royalties are defined as payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work (including cinematographic films, and audio and video tapes and disks and other means of reproduction); any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or information concerning industrial, commercial or scientific experience. The term "royalties" also includes gains from the alienation of any property described above which are contingent on the productivity, use, or disposition of the property.

The proposed treaty conforms to the U.S. internal law source rules in treating royalties as arising from U.S. sources if they are for the use of, or the right to use, property, information or experience in the United States.

The proposed treaty addresses the issue of non-arm's-length royalties between related parties (or parties having an otherwise special relationship) by stating that this article applies only to the

amount of arm's-length royalties. Any amount of royalties paid in excess of the arm's-length royalty is taxable according to the laws of each country, taking into account the other provisions of the proposed treaty. For example, excess royalties paid to a parent corporation by its subsidiary may be treated as a dividend under local law and thus entitled to the benefits of Article 10 (Dividends) of the proposed treaty.

### Article 14. Gains

#### *U.S. internal law*

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. A nonresident alien or foreign corporation is subject to U.S. tax on gain from the sale of a U.S. real property interest as if the gain were effectively connected with a trade or business conducted in the United States. "U.S. real property interests" include interests in certain corporations if at least 50 percent of the assets of the corporation consist of U.S. real property.

#### *Luxembourg internal law*

Under Luxembourg law, the taxation of capital gains, of both residents and nonresidents, generally is limited to certain gains that are business income or income from personal services. However, both a resident individual, and in some cases a nonresident, may be subject to a 20-percent Luxembourg tax on gain from the disposition of shares issued by a Luxembourg corporation, if the person is treated as having a substantial interest in the corporation. In addition, Luxembourg generally taxes the gain realized by a nonresident individual or foreign corporation on gain from the sale of real property located in Luxembourg.

#### *Proposed treaty limitations on internal law*

*Real property*

Under the proposed treaty, gains derived by a treaty country resident from the disposition of real property situated in the other country may be taxed in the other country. Real property situated in the other country for purposes of this article includes real property referred to in Article 6 (Income from Real Property) which is located in the other country and a United States real property interest, as defined under the Code (as of the date of signature and as it may be amended from time to time without changing the general principles). The Technical Explanation clarifies that distributions by a REIT that are attributable to gains derived from a disposition of real property are taxable under this article (and such gains are not taxable under the dividends article (Article 10)). Real property also includes shares or comparable corporate rights in a company that is a resident of Luxembourg, the assets of which consist for the greater part of real property situated in Luxembourg. According to the Technical Explanation, a nonresident generally is subject to Luxembourg tax upon a sale of shares in a Luxembourg real estate corporation only if the nonresident owns more than 25 percent of the corporation and either (1) holds the shares for a pe-

riod not exceeding six months or (2) had been a Luxembourg resident for more than fifteen years and became a nonresident for less than five years immediately prior to the sale.

*Other capital gains*

The proposed treaty contains a standard provision which permits a country to tax the gain from the alienation of personal property that is attributable to a permanent establishment or a fixed base located in that country. The proposed treaty generally does not permit the countries to tax any gains from the disposition of any property after such property ceases to be used in a U.S. trade or business. However, gains attributable to a permanent establishment or a fixed base, but received after the permanent establishment or fixed base is no longer in existence, are taxable in the country where the permanent establishment or fixed base existed (Article 7, paragraph 7).

Gains of an enterprise of one of the treaty countries from the alienation of ships, aircraft or containers operated in international traffic, and gains from the alienation of personal property pertaining to the operation of such ships, aircraft and containers, are taxable only in that country.

Generally, gains from the alienation of any property other than that discussed above are taxable under the proposed treaty only in the country where the alienator is a resident.

## Article 15. Independent Personal Services

### *U.S. internal law*

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. The performance of personal services within the United States may be a trade or business within the United States.

Under the Code, the income of a nonresident alien 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: (1) the individual is not in the United States for over 90 days during the taxable year; (2) the compensation does not exceed $3,000; and (3) the services are performed as an employee of, or under a contract with, a foreign person not engaged in a trade or business in the United States or are performed for a foreign office or place of business of a U.S. person.

### *Proposed treaty limitations on internal law*

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

Under the proposed treaty, income from the performance of independent personal services by a resident of one country is exempt

from tax in the other country unless the individual performing the services has a fixed base regularly available to him or her in the second country for the purpose of performing the activities. In that case, the nonresidence country may tax only that portion of the individual's income which is attributable to the fixed base.

The present treaty does not provide an exemption from source country tax for income from independent personal services. The exemption from source country tax provided in the proposed treaty for independent personal services income generally is similar to that contained in the U.S. and OECD models. Under the U.S. and OECD models, the nonresidence country may tax income from services provided in the residence country, assuming that the fixed base requirement is otherwise met. By contrast, under some U.S. tax treaties, the nonresidence country may only tax income from independent personal services if the services are performed there.

For purposes of this article in the proposed treaty, independent personal services include independent scientific, literary, artistic, educational, or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists, and accountants.

Under the proposed treaty, in determining taxable independent personal services income, the principles of paragraph 3 of Article 7 (Business Profits) are applicable to allow a taxpayer to deduct expenses that are incurred for purposes of the fixed base. According to the Technical Explanation, the taxpayer may deduct all relevant expenses, wherever incurred, in computing the net income from independent personal services subject to tax in the source country.

**Article 16. Dependent Personal Services**

Under the proposed treaty, wages, salaries, and other similar remuneration derived from services performed as an employee in one country (the source country) by a resident of the other country are taxable only in the country of residence if three requirements are met: (1) the individual is present in the source country for not more than 183 days in any twelve-month period beginning or ending during the taxable year concerned; (2) the individual's employer is not a resident of the source country; and (3) the compensation is not borne by a permanent establishment or fixed base of the employer in the source country. These limitations on source country taxation are generally consistent with the U.S. and OECD models. The present treaty limits the level of compensation that may be exempt from source country taxation to $3,000.

The proposed treaty provides that compensation derived from employment exercised continuously or predominately aboard a ship or aircraft operated in international traffic by an enterprise of one of the treaty countries may be taxed in the residence country of the enterprise. However, if the internal law of the residence country of the enterprise does not subject the income derived from such employment to tax, such income is taxable in the employee's country of residence. This provision was included at Luxembourg's request. The U.S. internal law generally does not tax the compensation of a nonresident derived from employment exercised aboard a ship or aircraft operated in international traffic by a U.S. enterprise.

This article is modified in some respects for directors' fees (Article 17), pensions, social security and annuities (Article 19), and government service (Article 20).

**Article 17. Directors' Fees**

Under the proposed treaty, directors' fees and other similar payments derived by a resident of one country for services rendered in the other country as a member of the board of directors of a company which is a resident of that other country may be taxed in that other country. This rule is the same as the rule under the U.S. model.

**Article 18. Artistes and Sportsmen**

Like the U.S. and OECD models, the proposed treaty contains rules that apply to the taxation of income earned by entertainers (such as theater, motion picture, radio, or television "artistes," or musicians) and sportsmen. These rules apply notwithstanding the other provisions dealing with the taxation of income from personal services (Articles 15 and 16) and business profits (Article 7), 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 this article of the proposed treaty, one country may tax an entertainer or sportsman who is a resident of the other country on the income from his or her personal services as such in the first country during any year in which the gross receipts derived by him or her from such activities, including reimbursed expenses, exceed $10,000 or its Luxembourg franc equivalent. Thus, if a Luxembourg entertainer maintained no fixed base in the United States and performed (as an independent contractor) for one day of a taxable year in the United States for gross receipts of $2,000, the United States could not tax that income. If, however, that entertainer's gross receipts were $30,000, the full $30,000 (less appropriate deductions) would be subject to U.S. tax. This provision does not bar the country of residence from also taxing that income (subject to a foreign tax credit). (See Article 25 (Relief From Double Taxation), below.) The Technical Explanation clarifies that because it is not possible to know whether the $10,000 (or the Luxembourg franc equivalent) is exceeded until the end of the year, the source country may subject all payments to an artiste or sportsman to withholding and refund any excess amount withheld.

According to the Technical Explanation, this article applies to all income directly connected with a performance by an entertainer or sportsman, such as appearance fees, award or prize money, and a share of the gate receipts. Income derived by an entertainer or sportsman from other than actual performance, such as royalties from record sales and payments for product endorsements, is not covered by this article; instead, these amounts are covered by other articles of the proposed treaty, such as Article 13 (Royalties) or Article 15 (Independent Personal Services). For example, if a Luxembourg entertainer receives royalty income from the sale of recordings of a concert given in the United States, the royalty income will be exempt from U.S. withholding tax under Article 13, even if the

remuneration from the concert itself may have been covered by this article.

The proposed treaty provides that where income in respect of activities exercised by an entertainer or sportsman in his or her capacity as such accrues not to the entertainer or sportsman but to another person, that income of that person may be taxed by the country in which the activities are exercised, unless it is established that neither the entertainer or sportsman nor persons related to him or her participate directly or indirectly in the profits of that other person in any manner, including the receipt of deferred remuneration, bonuses, fees, dividends, partnership distribution or other income distributions. (This provision applies notwithstanding the business profits and independent personal service articles (Articles 7 and 15).) This provision prevents certain entertainers and sportsmen from avoiding tax in the country in which they perform by, for example, routing the compensation for their services through a third entity such as a personal holding company or a trust located in a country that would not tax the income.

### Article 19. Pensions, Social Security, and Annuities

Under the proposed treaty, pensions and other similar remuneration derived and beneficially owned by a resident of either country in consideration of past employment generally are subject to tax only in the recipient's country of residence. This rule is subject to the provisions of Article 20 (Government Service). Thus, for example, it generally does not apply to pensions paid to a resident of one treaty country attributable to services performed for government entities of the other country. The Technical Explanation provides that this provision covers amounts paid by all private retirement plans and arrangements in consideration of past employment, regardless of whether they are considered qualified plans under the Code (including an individual retirement account).

Social security payments and other payments made under similar legislation by one country to an individual who is a resident of the other country or to a U.S. citizen are taxable only in the paying country.[13] This rule, which is not subject to the saving clause, exempts U.S. citizens and residents from U.S. tax on Luxembourg social security payments. This rule is subject to the provisions of Article 20 (Government Service). Under this rule, only the United States may tax U.S. social security payments to persons residing in Luxembourg. The rule thus safeguards the United States' right under the Social Security Amendments of 1983 to tax a portion of U.S. social security benefits received by nonresident individuals, while protecting any such individuals residing in Luxembourg from double taxation.

The proposed treaty provides that annuities may be taxed only in the country of residence of the person who derives and beneficially owns them. An annuity is defined as a stated sum payable periodically at stated times during a specified number of years, under an obligation to make the payments in return for adequate and full consideration (other than services rendered).

[13] The Notes state that it is understood that the term "other similar legislation" is intended to refer to U.S. tier 1 Railroad Retirement benefits.

**Article 20. Government Service**

Under the proposed treaty, remuneration, other than a pension, paid by a country or one of its political subdivisions or local authorities to an individual for services rendered to the payor generally is taxable in that country only. However, such remuneration is taxable only in the other country (the country that is not the payor) if the services are rendered in that other country, and the individual either (1) is a national of that other country, or (2) did not become a resident of that country solely for the purpose of rendering the services. Thus, for example, Luxembourg will not tax the compensation of a U.S. citizen and resident who is in Luxembourg to perform services for the U.S. Government, and the United States will not tax the compensation of a Luxembourg citizen and resident who performs services for the U.S. Government in Luxembourg.

Any pension paid by a country or one of its political subdivisions or local authorities, to an individual for services rendered to the payor generally is taxable only in that country. However, such pensions are taxable only in the other country if the individual is both a resident and a national of that other country.

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 16 (Dependent Personal Services), 17 (Directors' Fees), and 19 (Pensions, Social Security, and Annuities) will apply to remuneration and pensions for services rendered in connection with such business.

This article is an exception to the saving clause, pursuant to Article 1, paragraph 4(b) of the proposed treaty. Consequently, the saving clause does not apply to benefits conferred by this article to an individual who is neither a U.S. citizen nor a U.S. green-card holder. Thus, for example, the United States would not tax the compensation of a Luxembourg citizen who is not a U.S. green-card holder but who resides in the United States to perform services for the Luxembourg Government.

**Article 21. Students, Trainees, Teachers, and Researchers**

The treatment provided to students, trainees, teachers and researchers under the proposed treaty corresponds generally to the treatment provided under the present treaty. The U.S. and OECD models also provide some host-country exemptions for students and trainees, but do not contain corresponding language for teachers and researchers, although other U.S. treaties provide similar benefits.

Under the proposed treaty, a student, apprentice, or business trainee who visits the other country (the host country) for the purpose of full-time education at a recognized educational institution, or for full-time training, and who immediately before that visit, is or was a resident of the other treaty country, generally is exempt from tax in the host country on payments that he or she receives for the purpose of maintenance, education, or training. The Technical Explanation provides that it is not necessary for the payments to arise outside the host country. In the case of an apprentice or business trainee, this treaty benefit applies only for a period not exceeding two years from the date the individual first visits the

host country for the above purposes. If the visit exceeds two years, the host country may tax the individual under its internal law for the entire period of the visit, unless in a particular case the competent authorities of the two countries agree otherwise. In the case of a student, as under the present treaty, this treaty benefit applies regardless of the length of the stay.

Under the proposed treaty, a resident of a country who visits the other country (the host country) at the invitation of a university, college, school, or other recognized educational institution for the purpose of teaching, or engaging in research, or both, generally is exempt from tax in the host country on his or her remuneration for such teaching or research activities. This treaty benefit applies only for a period not more than two years from the date the individual first visits the host country for the above purposes. If the visit exceeds two years, the host country may tax the individual under its internal law for the entire period of the visit, unless in a particular case the competent authorities of the two countries agree otherwise. This exemption does not apply to income from research carried on for the benefit of any person other than the educational institution that extended the invitation to the researcher.

The Technical Explanation provides that the benefits accorded by this article are subject to anti-abuse provisions. Where a person visits for two years and leaves for a brief time and returns, an additional exemption is not available if the two visits are in substance treated as a single visit.

This article is an exception to the saving clause, pursuant to Article 1, paragraph 4(b) of the proposed treaty. Consequently, the saving clause does not apply to benefits conferred by this article to an individual who is neither a U.S. citizen nor a U.S. green-card holder. Thus, for example, the United States would not tax the compensation of a Luxembourg citizen who is not a U.S. green-card holder but who resides in the United States to perform research for a recognized educational institution.

### Article 22. Other Income

This article is a catch-all provision intended to cover items of income not specifically covered in other articles, and to assign the right to tax income from third countries to either the United States or Luxembourg. This article is substantially similar to the corresponding article in the U.S. model.

As a general rule, items of income not otherwise dealt with in the proposed treaty which are beneficially owned by residents of either country are taxable only in the country of residence. This rule, for example, gives the United States the sole right under the proposed treaty to tax income derived from sources in a third country and paid to a resident of the United States. This article is subject to the saving clause, so U.S. citizens who are Luxembourg residents would continue to be taxable by the United States on their third-country income, with a foreign tax credit provided for income taxes paid to Luxembourg.

The general rule just stated does not apply to income (other than income from real property (as defined in Article 6)) if the beneficial owner of the income is a resident of one country and carries on business in the other country through a permanent establishment

or a fixed base to which the income is attributable. In such a case, the provisions of Article 7 (Business Profits) or Article 15 (Independent Personal Services), as the case may be, will apply. Thus, for example, income arising outside the United States that is attributable to a permanent establishment maintained in the United States by a resident of Luxembourg generally would be taxable by the United States under Article 7 (Business Profits), even if the income was sourced in a third country.

The Technical Explanation provides that in cases in which a resident of a treaty country derives income from real property located outside the other treaty country (whether in the first treaty country or in a third country) that is attributable to the resident's permanent establishment or fixed base in the other treaty country, only the country of residence of the income recipient may tax that income. Thus, for example, if a U.S. resident has a Luxembourg permanent establishment and the resident derives income from real property located in a third country that is effectively connected with the Luxembourg permanent establishment, under the proposed treaty, only the United States may tax such income.

In addition, other income attributable to a permanent establishment or fixed base, but received after the permanent establishment or fixed base is no longer in existence, is taxable in the country where the permanent establishment or fixed base existed (Article 7, paragraph 7).

### Article 23. Capital

Luxembourg imposes a 0.5-percent capital tax on net worth. For residents of Luxembourg (individuals and corporations), the tax base is worldwide net worth. For nonresidents, the tax base generally includes real property situated in Luxembourg, assets belonging to a permanent establishment or a fixed base in Luxembourg, certain other business assets, certain intangibles registered in Luxembourg, and debt claims secured by Luxembourg real property.

The proposed treaty specifies the circumstances in which either treaty country may impose tax on capital owned by a resident of the country. Since the United States does not impose taxes on capital, the only capital taxes covered by the proposed treaty are those imposed by Luxembourg. Thus, although the article is drafted in a reciprocal manner, its provisions are relevant only for the imposition of Luxembourg tax. The Article was included at Luxembourg's request. The present treaty does not contain a similar provision.

The proposed treaty describes two situations under which Luxembourg may tax the capital of a U.S. resident. First, capital represented by real property (as defined in Article 6) which is owned by a U.S. resident and situated in Luxembourg may be taxed by Luxembourg. Second, capital represented by movable property forming part of the business property of a permanent establishment which a U.S. enterprise has in Luxembourg or pertaining to a fixed base available to a U.S. resident for the purpose of performing independent personal services may be taxed by Luxembourg.

The proposed treaty provides that capital represented by ships, aircraft or containers operated in international traffic (as defined in Article 8 (Shipping and Air Transport)) by an enterprise of ei-

ther country and other movable property pertaining to the operation of such ships, aircraft or containers is taxable only in the residence country of the enterprise. All other elements of capital of a resident of either country are taxable only in that country.

**Article 24. Limitation on Benefits**

***In general***

The proposed treaty contains a provision generally intended to limit indirect use of the treaty by persons who are not entitled to its benefits by reason of residence in the United States or Luxembourg, or in some cases, in another member country of the European Union ("EU") or North America Free Trade Agreement ("NAFTA").

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

***Summary of proposed treaty provisions***

The proposed new anti-treaty shopping article provides that a treaty country resident is entitled to all treaty benefits in the other country only if it is a "qualified resident" of the United States or Luxembourg. Alternatively, certain items of income of a treaty resident may qualify for treaty benefits if the resident satisfies one of several other tests of the proposed treaty. This provision of the proposed treaty is in some ways comparable to the U.S. Treasury regulation under the branch tax definition of a qualified resident.[14] However, the proposed treaty provides opportunities for treaty benefit eligibility which are not provided under the regulation.

Generally, a resident of either country qualifies for all the benefits accorded by the proposed treaty if such resident is a "qualified resident" as defined in one of the following categories:

(1) An individual;

(2) One of the treaty countries, a political subdivision or local authority thereof, or any agency or instrumentality of any such government, subdivision or authority;

[14] Treas. Reg. sec. 1.884–5.

(3) A company that satisfies an ownership test and a base erosion test;

(4) A company that satisfies a public company test;

(5) A company that is controlled by certain public companies and also satisfies a base erosion test; or

(6) A not-for-profit, tax-exempt organization that satisfies an ownership test.

Alternatively, a resident that does not fit into any of the above categories may claim treaty benefits with respect to certain items of income under the active business test or the derivative benefits test. Moreover, a treaty country resident is entitled to treaty benefits if the resident is otherwise approved by the source country's competent authority, in the exercise of the latter's discretion.

The proposed treaty, like the present treaty, denies treaty benefits to a resident that is a "1929" Luxembourg holding company and other companies that enjoy a similar special fiscal treatment under Luxembourg laws. In addition, the proposed treaty denies benefits with respect to certain income of a company that is owned primarily by persons who are not residents of either a treaty country or an EU or NAFTA country, if the shareholders in such company disproportionately participate in income from the other country.

Special rules apply to income derived by a resident of Luxembourg in certain "triangular" cases described below.

The Notes provide that a taxpayer claiming benefits under the ownership and base erosion tests, the public company test, or the derivative benefits test of the proposed treaty may be denied treaty benefits unless such a taxpayer demonstrates that the required percentage of its shares (including bearer shares) is beneficially owned by qualified residents, or where relevant, residents of the EU or NAFTA countries.

The competent authorities shall consult together with a view to developing a commonly agreed application of the provisions of this article, including the publication of regulations or other public guidance. In addition, the competent authorities shall, in accordance with Article 28 (Exchange of Information), exchange such information as is necessary for carrying out the provisions of this article.

### *Ownership and base erosion tests*

Like many U.S. treaties that have a limitation on benefits article, the proposed treaty contains an ownership test and a base erosion payment test, both of which must be met if an entity is to qualify for treaty benefits under this rule.

#### *Ownership test*

To meet the ownership test, it is necessary that at least 50 percent of the principal class of shares in the entity is ultimately owned by persons that qualify as treaty residents or U.S. citizens. The proposed treaty does not define the term "principal class of shares." According to the Technical Explanation, it is understood that the term generally refers to the ordinary or common shares of a company, provided that such class represents the majority of the voting power and value of the company. In a case where no single

class represents the majority of the company's voting power and value, the principal class of shares will be those classes that in the aggregate possess more than 50 percent of the voting power and value. In a case where multiple groups of classes of stock exist that account for more than 50 percent of the voting power and value of the shares, it is necessary that only one such group satisfies this requirement.

The proposed treaty does not define the term "ultimate owners" of a principal class of shares. The Technical Explanation provides that it is intended that an ultimate owner is the first person in the ownership chain that is a qualified resident of the proposed treaty determined without reference to its owners, and that intermediate owners of the company be disregarded. For this purpose, the category of qualified residents that may constitute ultimate owners are individuals, one of the treaty countries or a political subdivision or local authority thereof (or any agency or instrumentality), a company that satisfies the public company test, and a not-for-profit, tax-exempt organization where more than half of the beneficiaries, members or participants in such organization are qualified residents.

*Base erosion test*

To meet the base erosion test, not more than 50 percent of the gross income of the company for the year may be paid or accrued by the company as deductible amounts (under the laws of the company's residence country) to persons other than qualified residents or U.S. citizens. For purposes of the base erosion test, arm's length payments in the ordinary course of business for services or purchase or rentals of tangible property including immovable property are not taken into account in determining the amount of deductible payments made by the company. This test is intended to prevent a corporation, for example, from distributing most of its income in the form of deductible payments such as interest, royalties, service fees, or other amounts to persons not entitled to benefits under the proposed treaty.

### *Public company tests*

Like many other U.S. income tax treaties that have a limitation on benefits article, the proposed treaty contains a rule under which a company is entitled to treaty benefits if sufficient shares in the company are traded actively enough on a suitable stock exchange. This rule is similar to the branch profits tax rules in the Code under which a company is entitled to treaty protection from the branch tax if it meets such a test or if it is the wholly-owned subsidiary of certain publicly traded corporations resident in a treaty country.

*Publicly traded companies*

A company that is a resident of Luxembourg or the United States is entitled to treaty benefits if the principal class of its shares is substantially and regularly traded on one or more recognized stock exchanges. Thus, such a company is entitled to the benefits of the treaty regardless of where its actual owners reside or the amount or destination of payments it makes.

Under the proposed treaty, a company's shares are considered substantially and regularly traded on one or more recognized stock exchanges in a taxable year if the aggregate number of shares of that class traded in such stock exchange or exchanges during the immediately preceding taxable year is at least 6 percent of the average number of shares outstanding in that class during that taxable year. The Technical Explanation provides that the term "principal class of shares" has the same meaning as that term has for purposes of the ownership and base erosion tests above.

*Subsidiaries of publicly traded companies*

A company that is a resident of Luxembourg or the United States is entitled to treaty benefits if (1) it is controlled, directly or indirectly, by one or more companies which are residents of either treaty country, the principal classes of the shares of which are traded as described above, and (2) it satisfies the base erosion test described above (in connection with the ownership test). The Technical Explanation provides that control, for this purpose, refers to the ability to influence the actions of the company, but does not require a majority ownership.

*Other definitions*

For purposes of satisfying the public company tests, the term "recognized stock exchange" generally includes any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934, the Luxembourg Stock Exchange, the NASDAQ System owned by the National Association of Securities Dealers, and any other stock exchange agreed upon by the competent authorities of the two countries. The Notes provide that stock exchanges to be treated as "recognized" by agreement of the competent authorities include the principal stock exchanges of Amsterdam, Brussels, Frankfurt, Hamburg, London, Madrid, Milan, Paris, Sydney, Tokyo, and Toronto.

For purposes of satisfying the public company test for a "closely-held company" the term "recognized stock exchange" is the same as described above except it excludes the Luxembourg Stock Exchange and the NASDAQ System. The competent authorities also may agree to exclude certain other stock exchanges with respect to closely-held companies. Under the proposed treaty, a company is a "closely-held company" if 50 percent or more of its principal class of shares is owned by a specified category of persons each of whom beneficially owns, directly or indirectly, alone or together with related persons, more than 5 percent of such shares for more than 30 days during a taxable year. Under the proposed treaty, the specified category of persons are persons other than qualified residents of one of the treaty countries or residents of an EU or NAFTA country.

This exception to the definition of a "recognized stock exchange" in the case of a closely-held company has a counterpart in the regulations under Code section 884(e) for identifying a "qualified resident" eligible for treaty protection from the U.S. branch tax.[15] The

[15] Treas. Reg. sec. 1.884–5(d)(4)(iii).

regulation provides that stock in certain closely-held companies is not treated as "regularly traded." Thus, even though the proposed treaty has no special rule for closely-held companies in defining the term "substantial and regular trading," the proposed treaty may, by excluding from the public company test those companies traded on certain otherwise recognized exchanges, achieve a result that is in some cases similar to that achieved under the regulation. The class of closely-held companies to which the regulatory rule applies, however, is defined somewhat differently than the term "closely-held company" under the proposed treaty.

The rules for defining substantial and regular trading have a counterpart in the regulations under Code section 884(e).[16] The proposed treaty rules generally are, however, easier to satisfy. For example, the regulations require that the company's stock trade (other than in de minimis amounts) on a recognized stock exchange for at least 60 days of the year. In addition, the regulations require at least 10 percent of the aggregate number of shares be traded during the year.

***Non-profit organizations***

An entity also is entitled to benefits under the proposed treaty if it is a not-for-profit organization which, by virtue of that status, generally is exempt from income taxation in its country of residence, provided that more than half the beneficiaries, members, or participants in the organization are qualified residents.

***Active business test***

*In general*

Under the active business test, treaty benefits in the source country are available under the proposed treaty to an entity that is a resident of the United States or Luxembourg if it is engaged directly (or indirectly through an associated enterprise) in the active conduct of a trade or business in its residence country, and if the income derived from the source country is (1) derived in connection with that trade or business and the trade or business is substantial in relation to the proportionate interest in the activity carried on in the source country that generated the income, or (2) incidental to the trade or business in the residence country. The test is applied separately to each item of income.

An entity does not meet the active business test (and therefore cannot claim treaty benefits under this rule) by virtue of being engaged in the business of making or managing investments, unless these activities are carried on by a bank or insurance company.

*Income derived in connection with a substantial trade or business*

The proposed treaty specifies that an item of income is derived in connection with a trade or business if (1) the income accrues in the ordinary course of such trade or business and the beneficial owner owns, directly or indirectly, less than 5 percent of the shares (or other comparable rights) in the payor of the item of income, or (2) the income-producing activity in the source country is a line of business which forms a part of, or is complementary to, the trade

[16] Treas. Reg. sec. 1.884-5(d)(5).

or business conducted in the residence country by the income recipient.[17] Under the U.S. model, income is derived in connection with a trade or business only if the income producing activity in the source country is a line of business which forms a part of, or is complementary to, the trade or business conducted in the residence country by the income recipient. The U.S. model does not contain the proposed treaty's alternative definition for income derived in connection with a trade or business (i.e., income accrued in the ordinary course of business where the beneficial owner owns less than 5 percent of the payor).

Under the proposed treaty, income derived in connection with a trade or business is eligible for treaty benefits if the trade or business conducted in the residence country is substantial in relationship to the income-generating activity in the other country. Under the U.S. model, the trade or business in the residence country must also be "substantial" in cases where the income derived by the source country is "incidental" to the trade or business of the residence country. The proposed treaty does not apply a substantiality test to such incidental income.

Whether the trade or business of the income recipient is substantial generally is determined based on all the facts and circumstances. According to the Technical Explanation, the factors to be considered include the proportionate share of the trade or business in the other country, the nature of the activities performed, and the relative contributions made to the conduct of the trade or business in both countries.[18] However, the proposed treaty includes a safe harbor under which the trade or business of the income recipient is considered to be substantial if certain attributes of the residence-country business exceed a threshold fraction of the corresponding attributes of the trade or business located in the source country that produces the source-country income. Under this safe harbor, the attributes are assets, gross income, and payroll expense. The level of each such attribute in the active conduct of the trade or business by the income recipient in the residence country, and the level of each such attribute in the trade or business producing the income in the source country, is measured for the prior year. For each separate attribute, the ratio of the residence country level to the source country level is computed.

In general, the safe harbor is satisfied if the average of the three ratios is at least 10 percent, and each ratio separately is at least 7.5 percent. If any separate ratio is less than 7.5 percent for the prior year, the average of the corresponding ratios in the three prior years may be substituted. If a resident owns less than 100 percent of an activity in either country, the resident will only include its proportionate interest in such activity for purpose of computing the safe harbor percentages. These safe harbor percentages are similar to those contained in the U.S. model. The Technical Explanation clarifies that if the recipient and related persons of such

[17] Cf. Treas. Reg. sec. 1.884–5(e)(1). (To satisfy the active business test, the activities that give rise to the U.S. income must be part of a U.S. business and that business must be an integral part of an active trade or business conducted by the foreign corporation in its residence country.)

[18] Cf. Treas. Reg. sec. 1.884–5(e)(3). (A foreign corporation engaged in business in its residence country has a substantial presence in that country if certain of the attributes of that business, physically located in its residence country, equal at least a threshold percentage of its worldwide attributes.)

recipient do not have any ownership interest in the person from whom the income is derived, the substantiality test also will be satisfied because the denominator in each factor is zero and the numerators are positive.

*Income incidental to a trade or business*

Under the proposed treaty, income derived from one treaty country is incidental to a trade or business conducted in the other (residence) country if the income is not derived in connection with a trade or business as described above and the production of such income facilitates the conduct of the trade or business in the residence country. This definition is similar to that contained in the U.S. model. An example of such "incidental" income is income from the investment of the working capital of the residence country trade or business.

***Derivative benefits test***

The proposed treaty contains a reciprocal derivative benefits rule. This rule effectively allows a Luxembourg company to receive "derivative benefits" in the sense that it derives its entitlement to U.S. tax reductions in part from the U.S. treaty benefits to which its owners would be entitled if they earned the income directly. In order for this rule to apply to a company that is resident in a treaty country, at least 95 percent of the shares of the company must be owned by seven or fewer residents of one or more countries each one of which is a party to NAFTA or is a member of the EU and is a country with which the other treaty country has a comprehensive income tax convention. In addition, the company must satisfy a special base erosion test. Moreover, income for which certain benefits are claimed must satisfy a rate comparison test. The U.S. model does not contain a similar derivative benefits provision.

Under the special base erosion test, not more than 50 percent of the gross income of the company for the year may be paid or accrued by the company as deductible amounts (under the laws of the company's residence country) to persons other than U.S. citizens or residents of a country that is a member of the EU or a party to NAFTA. For purposes of the base erosion test, arm's length payments in the ordinary course of business for services or purchases or rentals of tangible property are not taken into account in determining the amount of deductible payments made by the company.

The proposed treaty imposes an additional condition for a company that is claiming benefits under the treaty with respect to certain types of income. Specifically, dividends, amounts subject to the branch tax, interest, or royalty payments in respect of which benefits are claimed under the proposed treaty must be subject to a rate of tax under the comprehensive treaty between the owner's residence country and the source country that is no less favorable than the rate of tax applicable to such company under the corresponding provisions of the proposed treaty. The Technical Explanation provides that if any of the owners accounting for the 95 percent interest in the company claiming benefits under the treaty do not satisfy this test with respect to a payment, then no treaty benefit would be available for that payment.

The Notes clarify that in applying the comparability requirement for dividends, the two tax rates that must be compared are the following:

(1) The tax rate that each of the owners of the company would be entitled to if such owner directly held its proportionate share of the shares that gave rise to the dividends; and

(2) The tax rate that each of the owners of the company, if such owner were a resident of the same country of which the recipient is a resident, would be entitled to under the proposed treaty if such owner directly held its proportionate share of the shares that gave rise to the dividends.

For purposes of the ownership test described above, a person is considered to be a resident of an EU or NAFTA country only if that person would be entitled to the benefits of a comprehensive income tax treaty between a member country and the country from which the benefits of the proposed treaty are being claimed. If the applicable treaty between the owner's country of residence and the source country does not contain a comprehensive limitation on benefits article (including provisions similar to the ownership and base erosion tests, the publicly traded company test (but not the subsidiary of a publicly traded company test) and the active business test of the proposed treaty), then the owner itself must satisfy the definition of a "qualified resident" under the proposed treaty as if it were a resident of either the United States or Luxembourg, as the case may be. Alternatively, the owner of the company claiming benefits must satisfy the active business test of the proposed treaty, provided that the item of income with respect to which treaty benefits are claimed is derived in connection with an active trade or business conducted by such owner within its own country of residence.

### *Grant of treaty benefits by the competent authority*

Finally, the proposed treaty provides a "safety-valve" for a treaty country resident that has not established that it meets one of the other more objective tests, but for which the allowance of treaty benefits would not give rise to abuse or otherwise be contrary to the purposes of the proposed treaty. Under this provision, such a person may be granted treaty benefits if the competent authority of the source country so determines.

The Technical Explanation provides that the competent authority of a country will base its determination on whether the establishment, acquisition, or maintenance of the person seeking benefits under the proposed treaty, or the conduct of such person's operations, has or had as one of its principal purposes the obtaining of benefits under the proposed treaty. Thus, persons that establish operations in either the United States or Luxembourg with the principal purposes of obtaining benefits under the proposed treaty ordinarily will be denied such benefits. The Technical Explanation also provides that in determining whether to grant discretionary relief, the competent authorities will take into account all relevant facts and circumstances, including the existence of a clear business purpose for the structure and location of the income earning entity in question, the conduct of an active trade or business by such entity, a valid business nexus between that entity and the activity giving

rise to the income, and the extent to which the entity would be entitled to treaty benefits comparable to those afforded by the proposed treaty if it had been incorporated in the country of residence of the majority shareholders. The competent authorities may determine to grant all, or partial, benefits of the proposed treaty.

This provision of the proposed treaty is similar to a portion of the qualified resident definition under the Code branch tax rules, under which the Secretary of the Treasury may, in his sole discretion, treat a foreign corporation as a qualified resident of a foreign country if the corporation establishes to the satisfaction of the Secretary that it meets such requirements as the Secretary may establish to ensure that individuals who are not residents of the foreign country do not use the treaty between the foreign country and the United States in a manner inconsistent with the purposes of the Code rule (sec. 884(d)(4)(D)).

***Triangular cases***

The Technical Explanation provides that although the proposed treaty is drafted reciprocally with respect to this issue, these rules have no application to the United States because the United States does not exempt the profits of a U.S. company attributable to its third-country permanent establishment.

Under present laws and treaties that apply to Luxembourg residents, it is possible for profits of a permanent establishment maintained by a Luxembourg resident in a third country to be subject to a very low aggregate rate of Luxembourg and third-country income tax. The proposed treaty, in turn, eliminates the U.S. tax on several specified types of income of a Luxembourg resident. In a case where the U.S. income is earned by a third-country permanent establishment of a Luxembourg resident (the so-called "triangular case") the proposed treaty has the potential of helping Luxembourg residents to avoid all (or substantially all) taxation, rather than merely avoiding double taxation.

The proposed treaty includes a special rule designed to prevent the proposed treaty from reducing or eliminating U.S. tax on income of a Luxembourg resident in a case where no other substantial tax is imposed on that income. Under the special rule, the United States is permitted to tax dividends, interest, and royalties paid to the third-country permanent establishment at the rate of 15 percent. In addition, under the special rule, the United States is permitted to tax other types of income without regard to the proposed treaty.

In order for the special rule to apply, four conditions must be satisfied. First, a Luxembourg enterprise must derive income from the United States. Second, such income must be attributable to a permanent establishment that the Luxembourg enterprise has in a third country. Third, the Luxembourg enterprise must be exempt from Luxembourg tax on the profits attributable to the third-country permanent establishment. Fourth, the combined Luxembourg and third-country taxation of the item of U.S.-source income earned by the Luxembourg enterprise with the third-country permanent establishment must be less than 50 percent of the Luxembourg tax that would be imposed if the income were earned by the same en-

terprise in Luxembourg and were not attributable to the permanent establishment.

The special rule does not apply if the U.S.-source income is derived in connection with, or is incidental to, the active conduct of a trade or business carried on by the permanent establishment in the third country (other than the business of making or managing investments unless these activities are banking or insurance activities carried on by a bank or insurance company). According to the Technical Explanation, the competent authority would grant relief in a case where the U.S.-source income subject to the special rule is ultimately included in a U.S. shareholder's income under the provisions of subpart F of part III of subchapter N of chapter 1 of subtitle A of the Code. Such relief is also found in other recent U.S. income tax treaties (e.g., the 1995 U.S.-France income tax treaty).

### *Denial of treaty benefits*

#### *Companies with disproportionate income participation*

Under the proposed treaty, treaty benefits are not available to the "disproportionate part" of the income derived from a treaty country by a company that is resident in the other country, if such company (or a company that controls it) has outstanding a class of shares (1) the terms of which, or arrangements with respect to which, entitle its holders to a portion of the income of the company derived from one treaty country that is larger than the portion such holders would receive absent such terms or arrangements, and (2) 50 percent or more of the vote and value of the company is owned by persons who are not qualified residents of either the United States, Luxembourg, or of another country that is a party to NAFTA or a member of the EU. The Technical Explanation provides that so-called alphabet stock that entitles the holders to earnings from the source country produced by a particular division or subsidiary of the company is included in the class of shares that entitle the holders to the disproportionate part of the company's income. The disproportionate part of the income is the part of the total income derived by the shareholder that is in excess of the amount that the shareholder would have derived absent any special terms that gave the shareholder a disproportionate entitlement to income derived from the source country.

#### *1929 holding companies and similar entities*

Like the present treaty, the proposed treaty denies treaty benefits to a Luxembourg holding company within the meaning of the Act (loi) of July 31, 1929 and the Decree (arrêté grand-ducal) of December 17, 1938, or any subsequent revisions thereof. In addition, other companies that enjoy similar Luxembourg tax incentives also are not eligible for treaty benefits. The Notes state that investment companies within the meaning of the Act dated March 30, 1988 constitute companies that enjoy similar Luxembourg tax incentives for purposes of this article.

## Article 25. Relief from Double Taxation

### *U.S. internal law*

One of the two principal purposes for entering into an income tax treaty is to limit double taxation of income earned by a resident of one of the countries that may be taxed by the other country. The United States seeks unilaterally to mitigate double taxation by generally allowing U.S. taxpayers to credit the foreign income taxes that they pay against U.S. tax imposed on their foreign source income. An indirect or "deemed-paid" credit is also provided. Under this rule, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from 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.

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 only offsets U.S. tax on foreign source income. The foreign tax credit 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. The limitation is computed separately for certain classifications of income (e.g., passive income and financial services income) in order to prevent the crediting of foreign taxes on certain high-taxed foreign source income against the U.S. tax on certain types of traditionally low-taxed foreign source income. Other limitations may apply in determining the amount of foreign taxes that may be credited against the U.S. tax liability of a U.S. taxpayer.

### *Luxembourg law*

Luxembourg unilaterally mitigates double taxation in several ways. First, the general rule of Luxembourg law that mitigates double corporate-level taxation—the so-called "participation exemption"—generally exempts a taxable Luxembourg company from corporate income tax on income (including dividends and stock gains) derived in connection with a "participation" in another entity, including in many cases a foreign company. A participation may be deemed to exist on the basis of a 10-percent or more shareholding in the entity in the case of dividends, and a 25-percent or more shareholding in the case of capital gains.

Luxembourg grants a foreign tax credit for taxes paid to another country by a Luxembourg corporation. The credit is generally subject to a per-country limitation. However, a taxpayer may elect to compute its foreign tax credit for taxes on foreign source interest and dividends using an overall limitation.

In addition, under some of its treaties, Luxembourg exempts certain other types of foreign income of a Luxembourg resident (such as business profits derived through a foreign permanent establishment, income from employment abroad, or income from foreign real property) from its domestic tax on a pro rata basis. In other words, Luxembourg tax on worldwide income is reduced in the same pro-

portion that exempt foreign income bears to worldwide income. This is also referred to as "exemption with progression," in light of the fact that all worldwide income is included in the tax base for purposes of determining the marginal rate of Luxembourg tax that applies.

### *Proposed treaty rules*

*Overview*

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 is engaged in business in both countries. Also, a corporation or individual may be treated as a resident of more than one country and be taxed on a worldwide basis by both.

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

The present treaty provides separate rules for relief from double taxation for the United States and Luxembourg. The present treaty generally provides for relief from double taxation of U.S. residents and citizens by requiring the United States to permit a credit against its tax for the appropriate amount of taxes paid to Luxembourg. The amount of Luxembourg taxes that are creditable is determined in accordance with U.S. law. The present treaty generally provides for relief from double taxation of Luxembourg residents by requiring Luxembourg to provide, in accordance with Luxembourg law, a deduction from Luxembourg tax with respect to U.S. source income, in order to take into account U.S. federal income taxes paid.

The present treaty contains a set of rules to determine the source of income under the treaty. These source rules apply in determining the foreign tax credit granted by either country to its residents or citizens under the treaty. For purposes of computing the U.S. foreign tax credit limitation, the source rules of the present treaty could result in a credit limitation which is different from that which would be arrived at in the absence of the treaty. The proposed treaty modifies this aspect of the present treaty by generally adopting the internal source rules of the country that allows the foreign tax credit. The modifications also include amending the rules applicable to U.S. citizens resident in Luxembourg.

*Proposed treaty limitations on U.S. internal law*

The proposed treaty generally provides that the United States will allow a citizen or resident a foreign tax credit for the income taxes imposed by Luxembourg. The proposed treaty also requires the United States to allow a deemed-paid credit, with respect to Luxembourg income tax, to any U.S. corporate shareholder of a Luxembourg company that receives dividends from such company

if the U.S. company owns 10 percent or more of the voting stock of the Luxembourg company.

The credit generally is to 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 treaty provisions). This provision is similar to those found in many U.S. income tax treaties.

Luxembourg taxes covered by the proposed treaty (Article 2 (Taxes Covered)), other than the capital tax and the portion of the communal trade tax that is computed on a basis other than profits, are considered income taxes for purposes of the U.S. foreign tax credit rules.

The proposed treaty, like other U.S. treaties, contains a special rule designed to provide relief from double taxation for U.S. citizens who are Luxembourg residents. Under the special rule, a U.S. citizen who is resident in Luxembourg will:

(1) Compute the tentative U.S. income tax and the tentative Luxembourg income tax with respect to items of income that, under the proposed treaty, are subject to Luxembourg tax and are either exempt from U.S. tax or are subject to a reduced rate of tax when derived by a Luxembourg resident who is not a U.S. citizen.

(2) Reduce the tentative Luxembourg tax by a hypothetical foreign tax credit for taxes imposed on his or her U.S.-source income. The amount of this credit is limited to the U.S. withholding tax that the citizen would have paid under the proposed treaty on such income if that person were a Luxembourg resident but not a U.S. citizen (e.g., 15 percent in the case of portfolio dividends).

(3) Reduce the tentative U.S. income tax by a foreign tax credit for income tax actually paid to Luxembourg as computed in step (2) (i.e., after Luxembourg allowed the credit for U.S. taxes). The proposed treaty recharacterizes the income that is subject to Luxembourg taxation as foreign source income for purposes of this computation.

The end result of this three-step formula is that the ultimate U.S. tax liability of a U.S. citizen who is a Luxembourg resident, with respect to an item of income, should not be less than the tax that would be paid if the individual were a Luxembourg resident and not a U.S. citizen.

*Proposed treaty limitations on Luxembourg internal law*

In general, the proposed treaty requires Luxembourg to exempt from its internal tax income derived by one of its residents that is subject to U.S. tax under the proposed treaty. However, Luxembourg may employ its "exemption with progression" method with respect to such income by taking the exempt income into the tax base for purposes of determining the rate of Luxembourg tax applicable to the remainder of the nonexempt income. In the case of an item taxable as a dividend (under either Article 10 or Article 12(6)(b))), the proposed treaty requires Luxembourg to provide the equivalent of a foreign tax credit to the taxpayer by reducing the otherwise applicable Luxembourg tax by the amount of U.S. withholding tax paid. The reduction may not exceed that part of the

Luxembourg tax (computed before the credit) that is attributable to the income that the United States may tax. A Luxembourg company that has held directly at least 10 percent of the capital of a U.S. company since the beginning of the Luxembourg company's accounting year is exempt from Luxembourg tax on U.S.-source dividends paid by such U.S. company, provided that the U.S. company is subject to U.S. tax that corresponds to the Luxembourg corporation tax. Moreover, such shares in the U.S. company also are exempt from the Luxembourg capital tax.

**Article 26. Non-Discrimination**

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

In general, under the proposed treaty, one country cannot discriminate by imposing other or more burdensome taxes (or requirements connected with taxes) on nationals of the other country than it would impose on its nationals in the same circumstances. This provision applies whether or not the nationals in question are residents of the United States or Luxembourg. A U.S. national who is not a resident of the United States and a Luxembourg national who is not a resident of the United States are not deemed to be in the same circumstances for U.S. tax purposes.

Under the proposed treaty, neither country may tax a permanent establishment of an enterprise of the other country, or remuneration of an individual resident of a country attributable to a fixed base in the other country, less favorably than it taxes its own enterprise or resident carrying on the same activities. However, nothing in this article will be construed as preventing the United States from imposing a branch profits tax (Article 11). Consistent with the U.S. and OECD models, a country is not obligated to grant residents of the other country any personal allowances, reliefs, or reductions for tax purposes on account of civil status or family responsibilities which it grants to its own residents.

In a provision not contained in the present treaty, each country is required (subject to the arm's-length pricing rules of Articles 9 (Associated Enterprises), 12 (Interest), and 13 (Royalties)) to allow its residents to deduct interest, royalties, and other disbursements paid by them to residents of the other country under the same conditions that it allows deductions for such amounts paid to residents of the same country as the payor. The Technical Explanation indicates that the term "other disbursements" is understood to include a reasonable allocation of executive and general administrative expenses, research and development expenses, and other expenses incurred for the benefit of a group of related enterprises. Similarly, any debts of an enterprise that is a resident of either country to a resident of the other country are deductible for the purposes of determining the taxable capital of the enterprise under the same conditions as if the debts had been contracted to a resident of the first country.

The nondiscrimination rule also applies under the proposed treaty to enterprises of one country that are owned in whole or in part by residents of the other country. Enterprises resident in one country, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other country, will not be subjected in the first country to any taxation or any connected requirement which is other or more burdensome than the taxation and connected requirements that the first country imposes or may impose on its similar enterprises.

U.S. internal law generally treats a corporation that distributes property in complete liquidation as realizing gain or loss as if the property had been sold to the distributee. If, however, 80 percent or more of the stock of the corporation is owned by another corporation, a nonrecognition rule applies and no gain or loss is recognized to the liquidating corporation. A special provision makes the nonrecognition provision inapplicable if the distributee is a foreign corporation (Code sec. 367(e)(2)). Even where the distributee is a foreign corporation resident in a treaty country, such treatment is not considered discriminatory, because absence of tax to the subsidiary in this case represents a complete elimination of U.S. tax jurisdiction over any appreciation, while a similar absence in the case of a domestic distributee simply shifts the appreciation into the hands of another U.S. taxpayer.[19] The Technical Explanation states that the application of Code section 367(e)(2) is consistent with the nondiscrimination article of the proposed treaty.

U.S. internal law permits corporations that satisfy certain conditions to elect to be treated as a pass-through entity. If this so-called "S corporation" election is made, the corporation would not be subject to federal income tax on its profits at the entity level; instead, the individual shareholders of the corporation would be taxed directly on such profits. The election is only available if all of the shareholders of the corporation are U.S. citizens or residents. The Technical Explanation confirms that the S corporation provisions, including the rule that prevents a nonresident alien from being a shareholder of an S corporation, are not in conflict with the nondiscrimination provisions of the proposed treaty.

U.S. internal law generally requires a partnership that engages in a U.S. trade or business to pay a withholding tax attributable to a foreign partner's share of the effectively-connected income of the partnership. The withholding tax is not the final liability of the partner, but is a prepayment of tax which will be refunded to the extend it exceeds a partner's final U.S. tax liability. No withholding is required with respect to a U.S. partner's share of the effectively-connected income of the partnership. The Technical Explanation provides that it is understood that the withholding tax is a reasonable collection mechanism, and that it is not in conflict with the nondiscrimination provisions of the proposed treaty.

The saving clause (which allows the United States to tax its citizens or residents notwithstanding certain treaty provisions) does not apply to the nondiscrimination article.

[19] See Notice 87–66, 1987–2 C.B.376.

**Article 27. Mutual Agreement Procedure**

The proposed treaty contains the standard mutual agreement provision, with some variation, which authorizes the competent authorities of the United States and Luxembourg to consult together to attempt to alleviate individual cases of double taxation not in accordance with the proposed treaty. The saving clause of the proposed treaty does not apply to this article, so that the application of this article may result in a waiver (otherwise mandated by the proposed treaty) of U.S. taxing jurisdiction over its citizens or residents.

Under this article, a resident of one country, who considers that the action of one or both of the countries results, or will result, in him or her paying a tax not in accordance with the proposed treaty, may present the case to the competent authority of the country of which he or she is a resident or citizen. The competent authority will then make a determination as to whether the objection appears justified. If the objection appears to be justified and if the competent authority is not itself able to arrive at a satisfactory solution, then the competent authority will endeavor to resolve the case by mutual agreement with the competent authority of the other country, with a view to the avoidance of taxation which is not in accordance with the proposed treaty. The provision authorizes a waiver of the statute of limitations of either country so as to permit the issuance of a refund or credit notwithstanding the statute of limitations.

The competent authorities of the countries are to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the proposed treaty. The proposed treaty makes express provision for the competent authorities to mutually agree on various issues including the attribution of income, deductions, credits, or allowances of a permanent establishment of an enterprise of a treaty country; the allocation of income, deductions, credits, or allowances; the characterization of particular items of income; the determination of the country in which the income arises; the common meaning of a term; and the elimination of double taxation in cases not provided for in the proposed treaty. The proposed treaty does not specify, as does the U.S. model, that the competent authorities may agree on the characterization of persons; advance pricing arrangements; the application of penalties, fines, and interest under internal law; and increases (where appropriate in light of economic or monetary developments) in the dollar thresholds in provisions such as the artistes and sportsmen article and the students and trainees provisions.

The proposed treaty authorizes the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of this mutual agreement article. This provision makes clear that it is not necessary to go through diplomatic channels in order to discuss problems arising in the application of the proposed treaty. It also removes any doubt as to restrictions that might otherwise arise by reason of the confidentiality rules of the United States or Luxembourg. The competent authorities shall consult together with a view to developing a commonly agreed application of the provisions of the proposed treaty, including the rules of Article 24 (Limitation on Benefits). The competent authori-

ties are authorized to prescribe regulations to carry out the purposes of the proposed treaty.

### Article 28. Exchange of Information

#### *Exchange of information*

*In general*

The proposed treaty contains a provision generally intended to prevent avoidance or evasion of taxes covered by the proposed treaty (principally income taxes), by providing for the exchange of information between the competent authorities of the treaty countries and for the provision of certain assistance in the collection of taxes. The proposed treaty does not cover exchanges of all types of information (e.g., information of financial institutions is excluded). In this regard, the proposed treaty is supplemented by a separate agreement, the Treaty between the United States of America and the Grand Duchy of Luxembourg on Mutual Legal Assistance in Criminal Matters ("MLAT"), described below.[20]

*Summary of proposed treaty provisions*

The proposed treaty provides for the exchange of information necessary to carry out the provisions of the proposed treaty or of the specified tax laws of the two countries provided that taxation under those domestic laws is not contrary to the proposed treaty. The exchange of information is not restricted by Article 1 (General Scope). Therefore, third-country residents are covered. Unlike the U.S. model, the proposed treaty obligates the parties to exchange information only with respect to taxes that are listed under Article 2 (Taxes Covered).

Any information exchanged is to be treated as secret in the same manner as information obtained under the domestic laws of the country receiving the information. The exchanged information may be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, administration, enforcement, prosecution or determination of appeals with respect to the taxes covered by the proposed treaty. The information exchanged may be used only for such purposes.[21] The Technical Explanation states that the appropriate committees of the U.S. Congress and the U.S. General Accounting Office will be afforded access to information for use in the performance of their role in overseeing the administration of U.S. tax laws. Exchanged information may be disclosed in public court proceedings or in judicial decisions. The Notes provide that the proposed treaty requires each country to provide the broadest possible measure of assistance with respect to matters covered by the proposed treaty. The Notes provide that the authorities in each country, including judicial authorities to the extent that they become involved in executing a request, will use their best efforts to provide the assistance requested.

As is true under the present treaty and the U.S. and OECD models, under the proposed treaty a country is not required to carry

[20] The proposed MLAT was signed on March 13, 1997.

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

out administrative measures at variance with the laws and administrative practices 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 competent authority of the requested country is to obtain the information to which the request relates in the same manner and to the same extent as if the tax at issue were its own tax. Where specifically requested by the competent authority of one country, the competent authority of the other country shall provide information in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writing) to the same extent that they can be obtained by such other competent authority under the laws and administrative practices of such other country.

The Notes clarify that the competent authority of the requested country will obtain and provide information, other than information of financial institutions, for any matter relating to these functions only in the same manner and to the same extent as if the competent authority of the requested country were obtaining the information for an investigation or a public court proceeding, under its own law and practices. Upon request, the competent authority of the requested country is required to obtain and provide authenticated copies of third-party books and records located in the requested country for any tax investigation or proceeding in the requesting country, so long as the laws and practices of the requested country would allow its tax authorities to obtain such information for an investigation or a public court proceeding under its laws.

The Technical Explanation states that the Luxembourg competent authority has adequate authority to compel the production of a wide variety of information, pursuant to a request from the U.S. competent authority. However, the Technical Explanation states that under Luxembourg internal law, Luxembourg tax authorities are prohibited from obtaining information from Luxembourg financial institutions for their own tax investigations and proceedings; thus, Luxembourg tax authorities are unable to obtain such information upon the request of U.S. tax authorities. The Notes further provide that information of Luxembourg financial institutions may be provided to U.S. authorities only in accordance with the terms of the proposed MLAT. The scope of the obligation is set forth in that agreement (as described below). The Notes provide that in the event that Luxembourg changes its laws and practices so that its tax authorities may obtain such information for purposes of enforcing and administering its own tax laws or the tax laws of member countries of the EU, such information will likewise be provided to the United States.

*Summary of proposed MLAT provisions relating to taxes*

The proposed MLAT covers mutual legal assistance and exchange of information in criminal matters. The proposed MLAT and accompanying exchange of diplomatic notes (the "MLAT

Notes") specify the scope of coverage regarding tax offenses. The requested country is required to provide assistance for offenses concerning value added taxes, sales taxes, excise taxes, custom duties and any other taxes that may be agreed to by the countries through an exchange of diplomatic notes. For offenses concerning other taxes (e.g., income taxes), the requested state must provide assistance only where the facts in a request establish a reasonable suspicion of "fiscal fraud" ("escroquerie fiscale"), as that term is defined in the proposed MLAT and the MLAT Notes. As used in the proposed MLAT, the term "fiscal fraud" means a criminal offense in which: (1) the tax involved, either as an absolute amount or in relation to an annual amount due, is significant, and (2) the conduct involved constitutes a systematic effort or a pattern of activity designed or tending to conceal pertinent facts from or provide inaccurate facts to the tax authorities. The requested country may not refuse assistance because its law does not impose the same kind of tax, or does not contain the same kind of tax regulations, as does the law of the requesting country.

The MLAT Notes state that the description of the tax offenses defined in the proposed MLAT as fiscal fraud for which assistance is available is in accord with the concept of "fiscal fraud" ("escroquerie fiscale") under Luxembourg law. The MLAT Notes provide that the Luxembourg concept of "escroquerie fiscale" is in accord with the concept of "fiscal fraud" under the laws of the United States, where a pattern of affirmative willful misconduct ("manoeuvres frauduleuses") exists, the likely effect of which would be to mislead tax authorities or conceal information from them. The MLAT Notes state that the United States and Luxembourg will consider that a pattern or combination of any one of the following activities designed or tending to conceal pertinent facts from, or provide inaccurate facts to, the tax authorities ("l'empoi systématique de manoeuvres frauduleuses") would create a presumption of an offense for which assistance is available under the proposed MLAT: (1) keeping a double set of books; (2) making false entries or alterations or false invoices or documents; (3) destroying books or records; (4) concealing assets or covering up sources of income; and (5) handling one's affairs to avoid making the records usual in transactions of the kind. The MLAT Notes state that Luxembourg's concept of "concealing pertinent facts from or providing inaccurate facts to the tax authorities" is comparable to the United States concept of "misleading tax authorities."

The proposed MLAT provides that information or evidence regarding a tax offense will be available for specified uses beyond the investigation or prosecution of the tax offense, including the assessment, collection, administration or enforcement in respect of taxes underlying that offense. Under the proposed MLAT, information or evidence which has been made public in the requesting country in the normal course of a proceeding for which it was provided may generally be used for any purpose. However, such information or evidence may not be used, among other things, for the prosecution of tax offenses for which assistance is not available under the proposed MLAT. For such offenses, information or evidence may not be used without the prior consent of the central authority of the requested country.

The proposed MLAT also provides rules relating to the appearance of persons to assist in investigations or proceedings and the safe conduct of those persons, to the transfer of persons in custody, to the location or identification of persons or items, to the service of documents, and to search and seizure.

***Assistance in collection***

The proposed treaty also provides for administrative cooperation between the two countries in collecting taxes to the extent necessary to ensure that treaty benefits do not inure to the benefits of persons not entitled to such benefits. The provisions of the proposed treaty are more detailed than the corresponding provisions of the U.S. model provision.

When one country applies to the other for assistance in the collection of taxes, its application must include a certification by its competent authority that the taxes are finally due and enforceable under its own laws. The Technical Explanation states that the concept of "finally due and enforceable" is to be applied under the same standard applicable to the U.S. income tax treaties with the Netherlands and Canada with respect to determining whether a claim is "finally determined" under those treaties. Therefore, a tax is finally due and enforceable when the applicant country has the right under its internal law to collect the tax and all administrative and judicial rights of the taxpayer to restrain collection in the applicant country have lapsed or been exhausted.

Under the proposed treaty, the certified document referred to above will be rendered enforceable in accordance with the laws of the requested country. The tax covered by the accepted request will be collected by the accepting country as though the tax were that country's own tax that has been finally determined. However, the tax will not have, in the accepting country, any priority accorded to the taxes of that country (e.g., in the case of a bankruptcy).

The proposed treaty provides that appeals concerning the existence or amount of the debt shall lie only to the competent tribunal of the requesting country. Similar to the U.S. model, the collection provision does not impose on either treaty country the obligation to carry out administrative measures of a different nature from those used in the collection of its own taxes, or that would be contrary to its sovereignty, security, public policy or essential interests. The Technical Explanation states that the term "essential interests" is not defined in the proposed treaty; however, it is understood that bank secrecy is not an essential interest.

**Article 29. Diplomatic Agents and Consular Officers**

The proposed treaty contains the rule found in other U.S. tax treaties that its provisions are not to affect the fiscal privileges of diplomatic agents or consular officials under the general rules of international law or the provisions of special agreements. Accordingly, the proposed treaty will not defeat the exemption from tax which a host country may grant to the salary of diplomatic officials of the other country. The saving clause does not apply in the application of this article to U.S. residents who are neither U.S. citizens nor green-card holders. Thus, Luxembourg diplomats who are considered U.S. residents generally may be protected from U.S. tax.

**Article 30. Entry Into Force**

The proposed treaty will enter into force on the day of the exchange of instruments of ratification. The provisions of the proposed treaty generally take effect for taxable years and periods beginning on or after the first day of January in the year following the date of entry into force. In the case of taxes payable at source, the proposed treaty generally takes effect for payments made on or after that first day of January.

Taxpayers may elect temporarily to continue to claim benefits under the present treaty with respect to a period after the proposed treaty takes effect. For such a taxpayer, the present treaty would continue to have effect in its entirety for the first assessment period or taxable year following the date on which the provisions of the proposed treaty would otherwise take effect. The present treaty ceases to have effect once the provisions of the proposed treaty take effect under the proposed treaty.

**Article 31. Termination**

The proposed treaty will continue in force until terminated by a treaty country. Either country may terminate it through diplomatic channels by giving notice at least six months before the end of any calendar year after the year the treaty has entered into force. Unlike many U.S. tax treaties, the proposed treaty does not contain the rule which provides that either country may terminate the treaty only after it has been in force for five years. A termination generally will be effective for taxable years and periods beginning on or after the first day of January following the expiration of the six month period. With respect to taxes payable at source, a termination will be effective for payments made on or after the first day of January following the expiration of the six month period.

## IV. ISSUES

The proposed treaty with Luxembourg, as supplemented by the Notes, presents the following specific issues.

### A. Treatment of REIT Dividends

***REITs in general***

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

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

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

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

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

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

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

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

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

***Foreign investors in REITs***

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

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

U.S. income tax treaties contain provisions limiting the amount of income tax that may be imposed by one country on residents of the other country. Many treaties, like the proposed treaty, generally allow the source country to impose not more than a 15-percent withholding tax on dividends paid to a resident of the other treaty country. In the case of real estate income, most treaties, like the proposed treaty, specify that income derived from, and gain from dispositions of, real property in one country may be taxed by the country in which the real property is situated without limitation.[22] Accordingly, U.S. real property rental income derived by a resident of a treaty partner generally is subject to the U.S. withholding tax at the full 30-percent rate (unless the net-basis taxation election is made), and U.S. real property gains of a treaty partner resident are subject to U.S. tax in the manner and at the rates applicable to U.S. persons.

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

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

Beginning in 1989, U.S. treaty negotiators began including in treaties provisions excluding REIT dividends from the reduced rates of withholding tax generally applicable to dividends. Under treaties with these provisions such as the proposed treaty, REIT dividends generally are subject to the full U.S. 30-percent withholding tax.[23]

***Analysis of treaty treatment of REIT dividends***

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

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

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

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

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

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

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

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

***Issue***

Under the present treaty with Luxembourg, as under many older U.S. tax treaties, the U.S. withholding tax on REIT dividends paid

to residents of Luxembourg is limited to a maximum rate of 15 percent. Under the proposed treaty, as under recent U.S. tax treaties, the reduced rates of U.S. withholding applicable to dividends generally do not apply to REIT dividends and, thus, REIT dividends paid to residents of Luxembourg may be subject to U.S. withholding tax at the full statutory rate of 30 percent. The Committee may wish to consider whether, in light of the competing considerations discussed above, the treatment of REIT dividends in the proposed treaty is appropriate.

## B. Treaty Shopping

### *In general*

The proposed treaty, like a number of U.S. income tax treaties, generally limits treaty benefits for treaty country residents so that only those residents with a sufficient nexus to a treaty country will receive treaty benefits. Although the proposed treaty generally is intended to benefit residents of Luxembourg and the United States only, residents of third countries sometimes attempt to use a treaty to obtain treaty benefits. This is known as treaty shopping. Investors from countries that do not have tax treaties with the United States, or from countries that have not agreed in their tax treaties with the United States to limit source country taxation to the same extent that it is limited in another treaty may, for example, attempt to reduce the tax on interest on a loan to a U.S. person by lending money to the U.S. person indirectly through a country whose treaty with the United States provides for a lower rate of withholding tax on interest. The third-country investor may attempt to do this by establishing in that treaty country a subsidiary, trust, or other entity which then makes the loan to the U.S. person and claims the treaty reduction for the interest it receives.

The anti-treaty-shopping provision of the proposed treaty is similar to anti-treaty-shopping provisions in the Code (as interpreted by Treasury regulations) and in several recent treaties. Some aspects of the provision, however, differ from the anti-treaty-shopping provision in the U.S. model. The proposed treaty provision resembles the anti-treaty-shopping provisions contained in the 1993 U.S. treaty with the Netherlands and the 1995 U.S. treaty with France. The degree of detail included in this provision and in the Netherlands and France provisions, relative to other treaties, is notable in itself. The proliferation of detail may reflect, in part, a diminution in the scope afforded the IRS and the courts in the anti-treaty-shopping provisions of most previous U.S. treaties to resolve interpretive issues adversely to a person attempting to claim the benefits of the treaty; this diminution represents a bilateral commitment, not alterable by developing internal U.S. tax policies, rules, and procedures, unless enacted as legislation that would override the treaty. (To the same extent as is provided under other treaties, the IRS generally is not limited under the proposed treaty in its discretion to allow treaty benefits under the anti-treaty-shopping rules.) In addition, the detail in the proposed treaty represents added guidance and certainty for taxpayers that may be absent under other treaties, although in many other U.S. treaties, the ne-

gotiators have chosen to forego such additional guidance in favor of somewhat simpler and more flexible provisions.

***Analysis of general provisions***

Anti-treaty-shopping articles in treaties often have a two-part "ownership and base erosion" test. Many recent treaty provisions and the anti-treaty-shopping provision of the U.S. branch tax provisions in the Code generally have ownership requirements that limit benefits to a company residing in a treaty country unless more than 50 percent of *all* classes of its stock is held by individual residents of either treaty country. The proposed treaty lowers the qualifying percentage to *at least* 50 percent of the *principal* class of stock. Thus, the ownership requirement under the proposed treaty is more generous to taxpayers than the corresponding requirements in other recent treaties. The U.S. model requires that at least 50 percent of *all* classes of the company's stock be owned by qualified persons for at least half the days during the company's taxable year. Because the ownership requirement in the U.S. model applies to all classes of the company's stock, and not to the principal class of stock as in the proposed treaty, the proposed treaty generally is more favorable to taxpayers than the corresponding requirements in the U.S. model.

The base erosion requirement in recent treaties denies treaty benefits if 50 percent or more of the resident's gross income is used, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to certain classes of persons not entitled to treaty benefits. A similar test applies under the branch tax rules under U.S. law. The base erosion test in the proposed treaty maintains the same 50-percent-or-more threshold as in recent treaties. The proposed treaty may be more favorable to taxpayers than other recent treaties and the U.S. model because the test treats as qualifying payments amounts that reflect arm's-length payments in the ordinary course of business for services or for the purchase or rental of tangible property including immovable property. This exception from base eroding payments is not provided for in the U.S. model.

The proposed treaty is similar to other U.S. treaties and the branch tax rules in affording treaty benefits to certain publicly traded companies. In comparison with the U.S. branch tax rules, the proposed treaty is more lenient. The proposed treaty allows benefits to be afforded to a company that is controlled, directly or indirectly, by one or more qualifying publicly traded corporations while the branch tax rules allow benefits to be afforded only to a wholly-owned subsidiary of a publicly traded company. The Technical Explanation provides that, for this purpose, the term control refers to the ability to influence the actions of the company, but does not require a majority (i.e., more than 50-percent) ownership. Thus, the proposed treaty's treatment of subsidiaries of publicly traded companies is more favorable relative to that in the corresponding provisions of other existing tax treaties. For example, in the U.S.-Netherlands treaty, more than 50 percent of the aggregate vote and value of the stock of the subsidiary must be owned by five or fewer publicly traded companies. As another example, in the U.S.-France treaty, more than 50 percent of the aggregate vote

and value of the stock of the subsidiary must be owned by any number of publicly traded companies.

Under the active business test in the anti-treaty-shopping article, treaty benefits in the source country will be available under the proposed treaty to an entity that is a resident of one country, if it is engaged in the active conduct of a trade or business in its residence country, and if either the income derived from the source country is incidental to that trade or business in the residence country, or such income is derived in connection with that trade or business and the trade or business is substantial in relation to the income producing activity. (This active trade or business test generally does not apply with respect to a business of making or managing investments, unless these activities are carried on by a bank or an insurance company.) The proposed treaty's active business test is similar to those found in recent treaties. As in some recent U.S. treaties, the proposed treaty attributes to the treaty resident active trades or businesses conducted by other entities in a complementary line of business. The attribution rules in the proposed treaty may result in more taxpayers being eligible for treaty benefits, and permit in some cases the treatment of third-country business operations as if they were carried on in Luxembourg. These rules are similar to those in the U.S.-Netherlands treaty and the U.S.-France treaty.

The proposed treaty includes a special rule designed to prevent the proposed treaty from reducing or eliminating U.S. tax on income of a Luxembourg resident in a case where no other substantial tax is imposed on that income (the so-called "triangular cases"). This is necessary because a Luxembourg resident may in some cases be wholly or partially exempt from Luxembourg tax on foreign (i.e., non-Luxembourg) income. The special rule applies generally if the combined Luxembourg and third-country taxation of U.S.-source income derived by a Luxembourg enterprise and attributable to a permanent establishment in the third country is less than 50 percent of the tax that would be imposed if the Luxembourg enterprise earned the income in Luxembourg.

Under the special rule, the United States is permitted to tax dividends, interest, and royalties paid to the third-country permanent establishment at the rate of 15 percent. In addition, under the special rule, the United States is permitted to tax other types of income without regard to the proposed treaty. The special rule generally does not apply if the U.S. income is derived in connection with, or is incidental to, an active trade or business in the third country. The special rule is similar to a provision of the 1993 protocol to the U.S.-Netherlands tax treaty and a provision of the U.S.-France treaty. These special rules for triangular cases are not provided for in the U.S. model.

The U.S.-France treaty provides a further exception from the application of the special rule for the triangular case if the third-country income is subject to taxation by either the United States or France under the controlled foreign corporation rules of either country.[24] A similar exception has been permitted under the U.S.-

[24] In the case of the United States, these provisions are contained in sections 951–964 of the Code and are referred to as the "subpart F" rules.

Netherlands protocol.[25] Although the proposed treaty does not provide an explicit controlled foreign corporation exception, the Technical Explanation states that the U.S. competent authority would grant relief in a case where the U.S.-source income subject to the special rule ultimately is included in a U.S. shareholder's income under the subpart F rules.

***Derivative benefits and discretionary competent authority relief***

The proposed treaty also provides mechanical rules under which so-called "derivative benefits" are afforded.[26] Under these rules, a Luxembourg entity is afforded benefits based in part on its ultimate ownership of at least 95 percent by seven or fewer residents of EU or NAFTA countries who would be entitled to U.S. treaty benefits that are as favorable under an existing treaty between the United States and the third country. The U.S. model does not contain a similar derivative benefits provision.

Taken as a whole, some may argue that the derivative benefits provisions of the proposed treaty are more generous to taxpayers claiming U.S. treaty benefits than the derivative benefits provisions of any U.S. tax treaties currently in effect. For example, while most other treaties to which the United States is a party generally allow derivative benefits only with respect to certain income (e.g., interest, dividends or royalties), the proposed treaty allows a taxpayer to claim derivative benefits with respect to the entire treaty.[27] In addition, unlike most existing treaties, the proposed treaty does not require *any* same-country ownership of a Luxembourg company claiming treaty benefits.[28] In other words, a Luxembourg entity that is 100-percent owned by certain third-country residents and that does not otherwise have a nexus with Luxembourg (e.g., by engaging in an active trade or business there), may be entitled to claim benefits under the proposed treaty.

Like other treaties and the branch tax rules, the proposed treaty permits the competent authority of the source country to allow benefits where the anti-treaty-shopping tests are not met. The Technical Explanation anticipates that the competent authority will base its determination on whether the establishment, acquisition, or maintenance of the person seeking benefits under the proposed treaty, or the conduct of such person's operations, has or had as one of its principal purposes the obtaining of benefits under the proposed treaty. This standard set forth in the Technical Explanation is similar to the standard of the U.S.-Netherlands treaty and other recent U.S. tax treaties.

[25] The IRS has announced that the U.S. competent authority will consider requests for relief from U.S. corporations that had a triangular case in place prior to the date of the signature of the 1993 protocol to the U.S.-Netherlands tax treaty. IRS New Release, December 5, 1994.

[26] The U.S. income tax treaties with the Netherlands, Jamaica, and Mexico also provide similar benefits.

[27] The U.S.-Jamaica tax treaty is the only other existing treaty that allows a taxpayer to claim derivative benefits with respect to the entire treaty.

[28] Article 26(4)(a) of the U.S.-Netherlands treaty, for example, requires more than 30-percent Dutch ownership of the entity claiming derivative benefits, and more than 70-percent EU ownership of such entity. On the other hand, the 1995 U.S.-Canada protocol permits a company to claim certain treaty benefits under the derivative benefits provision without any same country ownership; however, the benefits that may be so obtained are limited to reduced withholding rates for dividends, interest and royalties.

In the case of the U.S.-Netherlands treaty, the staff understands that the competent authority has granted discretionary benefits under that treaty to certain Dutch companies established to maximize U.K. foreign tax credits (the so-called "dividend mixer" holding companies). Some have argued that because the derivative benefits provisions of the proposed treaty do not require any same-country ownership, a Luxembourg dividend mixer holding company should satisfy the derivative benefits provisions, and thus it will be unnecessary for such a company to apply for competent authority relief.

***Issues***

The practical difference between the proposed treaty tests and the corresponding tests in most predecessor treaties will depend upon how they are interpreted and applied. For example, the more subjective active business tests in other treaties theoretically might be applied leniently (so that any colorable business activity suffices to preserve treaty benefits), or they may be applied strictly (so that the absence of a relatively high level of activity suffices to deny them). Given the bright line rules provided in the proposed treaty, the range of interpretation under it may be narrower. It may be possible that a relatively narrow reading of the active business test in other treaties and the branch tax regulations could theoretically be stricter than the proposed treaty tests, and could operate to deny benefits in potentially abusive situations more often.

The Committee has in the past expressed its belief that the United States should maintain its policy of limiting treaty-shopping opportunities whenever possible. The Committee has further expressed its belief that, in exercising any latitude Treasury has with respect to the operation of a treaty, the treaty rules should be applied to deter treaty-shopping abuses. On the other hand, implementation of the tests for treaty shopping set forth in the proposed treaty raise factual, administrative, and other issues. The Committee may wish to satisfy itself that the anti-treaty-shopping rules in the proposed treaty are adequate under the circumstances.

## C. Insurance Excise Tax

The proposed treaty, unlike the present treaty, covers the U.S. excise tax on insurance premiums paid to foreign insurers. However, in a departure from all existing U.S. tax treaties that cover the excise tax on insurance premiums, the excise tax on reinsurance premiums is not covered by the proposed treaty.

With the waiver of the excise tax on insurance premiums, for example, a Luxembourg insurer without a permanent establishment in the United States can collect premiums on policies covering a U.S. risk or a U.S. person free of the excise tax on insurance premiums. However, the tax is imposed to the extent that the risk is reinsured by the Luxembourg insurer with a person not entitled to the benefits of an income tax treaty providing exemption from the tax. This latter rule is known as the "anti-conduit" clause.

Such waivers of the excise tax have raised serious congressional concerns. For example, concern has been expressed over the possibility that such waivers may place U.S. insurers at a competitive disadvantage with respect to foreign competitors in U.S. markets

if a substantial tax is not otherwise imposed (e.g., by the treaty partner country) on the insurance income of the foreign insurer (or, if the risk is reinsured, the reinsurer). Moreover, in such case, a waiver of the tax does not serve the primary purpose of treaties to prevent double taxation, but instead has the undesirable effect of eliminating all tax on such income.

The U.S.-Barbados and U.S.-Bermuda tax treaties each contained such a waiver as originally signed. In its report on the Bermuda treaty, the Committee expressed the view that those waivers should not have been included. The Committee stated that waivers should not be given by Treasury in its future treaty negotiations without prior consultations with the appropriate committees of Congress.[29] Congress subsequently enacted legislation to ensure the sunset of the waivers in the two treaties. The insurance excise tax also is waived in the treaty with the United Kingdom (without the so-called "anti-conduit rule"). The inclusion of such waiver in that treaty has been followed by a number of legislative efforts to redress the perceived competitive imbalance created by the waiver.

The issue is whether the waiver of the insurance excise tax in the proposed treaty is consistent with the Committee's view of good tax treaty policy. Furthermore, the Committee may wish to satisfy itself that the Luxembourg income tax imposed on Luxembourg insurance companies on insurance premiums results in a burden that is substantial in relation to the U.S. tax on U.S. insurance companies.

## D. Exchange of Information

One of the principal purposes of the proposed income tax treaty between the United States and Luxembourg is to prevent avoidance or evasion of income taxes of the two countries. The exchange of information article of the proposed treaty is one of the primary vehicles used to achieve that purpose.

The exchange of information article contained in the proposed treaty generally conforms to the corresponding article of the OECD model and the U.S. model. As is true under these model treaties and the present treaty, under the proposed treaty a country is not required to carry out administrative measures at variance with the laws and administrative practice of either country, to supply information which is not obtainable under the laws or in the normal course of the administration of either country, or to supply information which discloses any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which is contrary to public policy.

The exchange of information article contained in the proposed treaty is somewhat narrower in scope (and consequently less useful) than the provisions of the Convention on Mutual Administrative Assistance in Tax Matters, which has been ratified by the United States but not by Luxembourg. In addition, the exchange of information article contained in the proposed treaty provides that information exchanged is to be treated as secret in the same manner as information obtained under the domestic laws of the country receiving the information. This conforms to the U.S. model and the

[29] Limited consultations took place in connection with the proposed treaty.

OECD model. The Convention on Mutual Administrative Assistance in Tax Matters, however, provides that if the party supplying the information has more restrictive conditions of secrecy, the more restrictive provisions apply. This approach generally ensures that information supplied, for example, by the United States to another party is accorded at least the same confidentiality protections accorded to the information in the United States. This may provide greater assurance of protection of confidentiality. On the other hand, the rule contained in the proposed treaty (as well as the U.S. model and the OECD model) is much easier for the receiving country to administer than the rule in the Convention. For this reason, the rule in the proposed treaty has been the generally accepted, long-standing rule with respect to exchange of information.

The Technical Explanation states that Luxembourg bank secrecy laws prohibit Luxembourg tax authorities from obtaining information from Luxembourg financial institutions for their own tax investigations and proceedings. Consequently, the Luxembourg competent authority would not be able to provide such information upon the request of the U.S. competent authority. However, the Notes provide that such information may be provided to the U.S. competent authority in accordance with the terms of the proposed MLAT. MLATs are negotiated and administered by the U.S. Justice Department and are used for the exchange of information in criminal matters. Because the provisions of the MLAT would apply only to criminal investigations, the United States may not obtain financial institution information from Luxembourg in cases involving non-criminal matters.

With regard to criminal tax offenses, the proposed MLAT generally requires that assistance be provided only with respect to offenses concerning specifically enumerated taxes (e.g., value added taxes, sales taxes, excise taxes and custom duties).[30] The proposed MLAT imposes a higher standard before assistance can be provided with respect to offenses concerning other taxes (e.g., income taxes): assistance will not be available unless the facts establish a reasonable suspicion of "fiscal fraud." This is defined to be a criminal offense in which the tax involved (either as an absolute amount or in relation to an annual amount due) is significant, and in which the conduct involved constituted a systematic effort or pattern of activity tending to conceal facts from, or provide inaccurate facts to, the tax authorities. Thus, with respect to income taxes covered under the proposed treaty, assistance under the proposed MLAT would not be available if this threshold inquiry were not satisfied.

Some have argued that the imposition under the proposed MLAT of a higher standard before assistance can be provided with respect to income taxes may disadvantage the United States in obtaining assistance with respect to its principal form of taxation, in comparison with the lower standard for assistance with respect to value added taxes, which are imposed by Luxembourg and not the United States. Others have responded that requiring reasonable suspicion of fiscal fraud before assistance can be provided with respect to income taxes may not be a significant impediment in most U.S.

[30] Under the proposed MLAT, this rule would also apply to any other taxes hereinafter agreed to by both countries through an exchange of diplomatic notes.

criminal income tax cases. This is so because, first, U.S. criminal income tax cases generally do involve an amount of tax that is significant, and second, systematic concealment or the provision of inaccurate facts is a common element of many U.S. criminal income tax cases.

As stated earlier, the exchange of information provisions are used to achieve one of the principal purposes of the proposed treaty and, thus, are a vital part of the proposed treaty. The proposed treaty does not cover exchanges of all types of information (e.g., information of financial institutions is excluded). In this regard, the proposed treaty is supplemented by the proposed MLAT. However, the rights of each country to obtain tax information under the proposed MLAT also are limited. The Committee may wish to satisfy itself that the exchange of information provisions in the proposed treaty and the proposed MLAT are adequate under the circumstances. Because information exchange may not be adequate unless both agreements were implemented, the Committee may also wish to consider whether ratification of the proposed treaty and the proposed MLAT by the United States should be linked.

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