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

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

ON OCTOBER 13, 1999

PREPARED BY THE STAFF

OF THE

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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 of America and the Republic of Latvia ("Latvia"). The proposed treaty was signed on January 15, 1998.[2] The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed treaty on October 13, 1999.

Part I of the pamphlet provides a summary with respect to the proposed 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 treaty. Part IV contains a discussion of issues with respect to the proposed 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 Republic of Latvia* (JCS–6–99), October 8, 1999].

[2] For a copy of the proposed treaty, see Senate Treaty Doc. 105–57, June 26, 1998.

I. SUMMARY

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

As in other U.S. tax treaties, these objectives principally are achieved through each country's agreement to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other country. For example, the proposed treaty contains provisions under which each country generally agrees not to tax business income derived from sources within that country by residents of the other country unless the business activities in the taxing country are substantial enough to constitute a permanent establishment or fixed base (Articles 7 and 14). Similarly, the proposed treaty contains "commercial visitor" exemptions under which residents of one country performing personal services in the other country will not be required to pay tax in the other country unless their contact with the other country exceeds specified minimums (Articles 14, 15, and 17). The proposed treaty provides that dividends, interest, royalties, and certain capital gains derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles 10, 11, 12, and 13); however, the rate of tax that the source country may impose on a resident of the other country on dividends, interest, and royalties generally will be limited by the proposed treaty (Articles 10, 11, and 12).

In situations where the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the proposed treaty generally provides for relief from the potential double taxation through the allowance by the country of residence of a tax credit for certain foreign taxes paid to the other country (Article 24).

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

The proposed treaty also contains a detailed limitation on benefits provision to prevent the inappropriate use of the treaty by third-country residents (Article 23).

No income tax treaty between the United States and Latvia is in force at present. The proposed treaty is similar to other recent U.S. income tax treaties, the 1996 U.S. model income tax treaty ("U.S. model"), the model income tax treaty of the Organization for Economic Cooperation and Development ("OECD model"), and the United Nations Model Double Taxation Convention between Developed and Developing Countries (the "U.N. model"). However, the proposed treaty contains certain substantive deviations from those treaties and models.

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

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

A. U.S. Tax Rules

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

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

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

Specific statutory exemptions from the 30-percent withholding tax are provided. For example, certain original issue discount and certain interest on deposits with banks or savings institutions are exempt from the 30-percent withholding tax. An exemption also is provided for certain interest paid on portfolio debt obligations. In addition, income of a foreign government or international organization from investments in U.S. securities is exempt from U.S. tax.

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

Rules are provided for the determination of the source of income. For example, interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation generally are considered U.S.-source income. Conversely, dividends and interest paid by a foreign corporation generally are treated as foreign-source income. Special rules apply to treat as foreign-source income (in whole or in part) interest and dividends 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 (or an amount is included in income).

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 relevant 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, U.S. treaties generally contain an "anti-treaty shopping" provision that is designed to limit treaty benefits to bona fide residents of the two countries.

III. EXPLANATION OF PROPOSED TREATY

A detailed, article-by-article explanation of the proposed income tax treaty between the United States and Latvia is set forth below.

Article 1. General Scope

Overview

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

The proposed treaty generally applies to residents of the United States and to residents of Latvia, with specific modifications to such scope provided in other articles (*e.g.*, Article 25 (Nondiscrimination) and Article 27 (Exchange of Information and Administrative Assistance)). This scope is consistent with the scope of other U.S. income tax treaties, the U.S. model, and the OECD model. For purposes of the proposed treaty, residence is determined under Article 4 (Resident).

The proposed treaty provides that it does not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance accorded by internal law or by any other agreement between the United States and Latvia. Thus, the proposed treaty will not apply to increase the tax burden of a resident of either the United States or Latvia. According to the Treasury Department's Technical Explanation (hereinafter referred to as the "Technical Explanation"), the fact that the proposed treaty only applies to a taxpayer's benefit does not mean that a taxpayer may select inconsistently among treaty and internal law provisions in order to minimize its overall tax burden. In this regard, the Technical Explanation sets forth the following example. Assume a resident of Latvia has three separate businesses in the United States. One business is profitable and constitutes a U.S. permanent establishment. The other two businesses generate effectively connected income as determined under the Internal Revenue Code (the "Code"), but do not constitute permanent establishments as determined under the proposed treaty; one business is profitable and the other business generates a net loss. Under the Code, all three businesses would be subject to U.S. income tax, in which case the losses from the unprofitable business could offset the taxable income from the other businesses. On the other hand, only the income of the business which gives rise to a permanent establishment is taxable by the United States under the proposed treaty. The Technical Explanation makes clear that the taxpayer may not invoke the proposed treaty to exclude the profits of the profitable business that does not constitute a permanent establishment and invoke U.S. internal law to claim the loss of the unprofitable business that does not constitute a permanent establishment to offset the taxable income of the permanent establishment.[3]

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

Saving clause

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

The proposed treaty contains a provision under which the saving clause (and therefore the U.S. jurisdiction to tax) applies to a former U.S. citizen or a former long-term resident (whether or not treated as such under Article 4 (Resident)), whose loss of citizenship or resident status, respectively, 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 or resident status. Section 877 of the Code provides special rules for the imposition of U.S. income tax on former U.S. citizens and long-term residents for a period of ten years following the loss of citizenship or resident status; these special tax rules apply to a former citizen or long-term resident only if his or her loss of U.S. citizenship or resident status had as one of its principal purposes the avoidance of U.S. income, estate, or gift taxes. 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.

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

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

from residence country tax for social security benefits and certain child support payments (Article 18, paragraphs 2 and 5); relief from double taxation through the provision of a foreign tax credit (Article 24); protection from discriminatory tax treatment with respect to transactions with residents of the other country (Article 25); and benefits under the mutual agreement procedures (Article 26). These exceptions to the saving clause permit residents or citizens of the United States or Latvia to obtain such benefits of the proposed treaty with respect to their country of residence or citizenship.

In addition, the saving clause does not apply to the following benefits conferred by one of the countries upon individuals who neither are citizens of that country nor have been admitted for permanent residence in that country. Under this set of exceptions to the saving clause, the specified treaty benefits are available to, for example, a Latvian citizen who spends enough time in the United States to be taxed as a U.S. resident but who has not acquired U.S. permanent residence status (*i.e.*, does not hold a "green card"). The benefits that are covered under this set of exceptions are the exemptions from host country tax for certain compensation from government service (Article 19), certain income received by students, trainees, or researchers (Article 20), and certain income of diplomats and consular members (Article 28).

Article 2. Taxes Covered

The proposed treaty generally applies to the income taxes of the United States and Latvia. However, Article 25 (Nondiscrimination) is applicable to all taxes imposed at all levels of government, including State and local taxes. Moreover, Article 27 (Exchange of Information and Administrative Assistance) generally is applicable to all national-level taxes, including, for example, estate and gift taxes.

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

In the case of Latvia, the proposed treaty applies to the enterprise income tax (uznemumu ienakuma nodoklis) and the personal income tax (iedzivotaju ienakuma nodoklis).

The proposed treaty also contains a rule generally found in U.S. income tax treaties which provides that the proposed treaty applies to any identical or substantially similar taxes that may be imposed subsequently in addition to or in place of the taxes covered. The proposed treaty obligates the competent authority of each country to notify the competent authority of the other country of any significant changes in its internal tax laws or of any official published materials concerning the application of the treaty, including explanations, regulations, rulings, or judicial decisions. The Technical Explanation states that this requirement relates to changes that are significant to the operation of the proposed treaty.

Article 3. General Definitions

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

The term "United States" means the United States of America, but does not include Puerto Rico, the Virgin Islands, Guam, or any other U.S. possession or territory. When used in the geographical sense, the term "United States" also includes the territorial sea of the United States, and for certain purposes, the definition is extended to include the sea bed and subsoil of undersea areas adjacent to the territorial sea of the United States. This extension applies to the extent that the United States exercises sovereignty in accordance with international law for the purpose of natural resource exploration and exploitation of such areas. This extension of the definition applies, however, only if the person, property, or activity to which the proposed treaty is being applied is connected with such natural resource exploration or exploitation. Thus, the Technical Explanation concludes that the term "United States" would not include any activity involving the sea floor of an area over which the United States exercised sovereignty for natural resource purposes if that activity was unrelated to the exploration and exploitation of natural resources.

The term "Latvia" means the Republic of Latvia and, when used in the geographical sense, means the territory of the Republic of Latvia and any other area adjacent to the territorial waters of the Republic of Latvia within which under the laws of Latvia and in accordance with international law, the rights of Latvia may be exercised with respect to the sea bed and its sub-soil and their natural resources.

The term "person" includes an individual, an estate, a trust, a partnership, a company, and any other body of persons.

A "company" under the proposed treaty is any body corporate or any entity which is treated as a body corporate for tax purposes.

The terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean, respectively, an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State. The proposed treaty does not define the term "enterprise." However, despite the absence of a clear, generally accepted meaning, the Technical Explanation states that the term is understood to refer to any activity or set of activities that constitute a trade or business. The terms "a Contracting State" and "the other Contracting State" mean the United States or Latvia, according to the context in which such terms are used.

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

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). On interpretative issues, the latter acts with the concurrence of the Associate Chief Counsel (International) of the IRS. The Latvian "competent authority" is the Minister of Finance or his authorized representatives.

The term "national" means (1) any individual possessing the nationality of a treaty country; and (2) any legal person, partnership, or association deriving its status as such from the laws in force in a treaty country.

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

Article 4. Resident

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

Internal taxation rules

United States

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

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

Latvia

A company is considered to be a resident of Latvia if it is established and registered, or is required to be established and registered, in accordance with Latvian law. Resident companies are subject to Latvian taxation on their worldwide income. Nonresident companies are subject to Latvian taxation with respect to income that is attributable to a permanent establishment located in Latvia.

Individuals are considered to be Latvian residents if they reside in Latvia 183 days or more during a 12 month period beginning or ending within a taxable year, or if their permanent place of residence is in Latvia. Latvian residents are subject to tax on their worldwide income, while nonresident individuals are subject to Latvian tax only on income earned in Latvia.

All payments made to nonresidents situated, established, or founded in tax havens listed by the government (approximately 55 jurisdictions are listed) are subject to withholding at a rate of 25 percent, unless the payor proves that the recipient is not affiliated with the payor.

Proposed treaty rules

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

The proposed treaty generally defines "resident of a Contracting State" to mean any person who, under the laws of that country, is liable to tax in that country by reason of the person's residence, domicile, citizenship, place of management, place of incorporation, or any other criterion of a similar nature. The term "resident of a Contracting State" does not include any person that is liable to tax in that country only on income from sources in that country. According to the Technical Explanation, the reference in the proposed treaty to persons "liable to tax" in a country is interpreted as referring to those persons subject to the taxation laws of such country; the reference therefore includes REITs that are subject to the tax laws of a country (even though such organizations generally do not pay tax). The determination of whether a citizen or national is considered a resident of the United States or Latvia is made based on the principles of the treaty tie-breaker rules described below.

The proposed treaty provides that the income of a partnership, estate, or trust is considered to be the income of a resident of one of the treaty countries only to the extent that such income is subject to tax in that country as the income of a resident, either in its hands or in the hands of its partners or beneficiaries. Under this provision, for example, if the U.S. partners' share of the income of a U.S. partnership is only one-half, the proposed treaty's limitations on withholding tax rates would apply to only one-half of the Latvian source income paid to the partnership.

The proposed treaty provides that an individual who is a resident (as defined above) of a treaty country due to his or her citizenship or permanent residency (*i.e.*, a "green card" holder), and is not a resident of the other treaty country, will be considered a resident of the first treaty country only if he or she has a substantial presence, permanent home, or habitual home in such country.

The proposed treaty also considers a resident to include (1) a treaty country, political subdivision, or a local authority thereof, and any agency or instrumentality of the treaty country, subdivision, or local authority; and (2) a legal person organized under the laws of a treaty country and that is generally exempt from tax in the treaty country because it is established and maintained either (i) exclusively for a religious, charitable, educational, scientific, or other similar purpose; or (ii) to provide pensions or other similar benefits to employees pursuant to a plan. The Technical Explanation states that the term “similar benefits” is intended to encompass employee benefits such as health and disability benefits.

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

If a company would be a resident of both countries under the basic definition in the proposed treaty, the competent authorities of the countries will attempt to settle the question of residence by mutual agreement. If a mutual agreement cannot be reached, the company will not be considered to be a resident of either country for purposes of enjoying benefits under the proposed treaty.

In the case of any person other than an individual or a company that would be a resident of both countries under the basic definition in the proposed treaty, the proposed treaty requires the competent authorities to settle the issue of residence by mutual agreement and to determine the mode of application of the proposed treaty to such person.

Article 5. Permanent Establishment

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

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

In general, under the proposed treaty, a permanent establishment is a fixed place of business through which the business of an enterprise is wholly or partly carried on. A permanent establishment includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources. It also includes a building site or a construction or installation project, if the site or project continues for more than six months. The Technical Explanation states that the six-month test applies separately to each individual site or project, with a series of contracts or projects that are interdependent both commercially and geographically treated as a single project. The Technical Explanation further states that if the six-month threshold is exceeded, the site or project constitutes a permanent establishment as of the first day that work in the country began. The U.S. model contains similar rules, but the threshold period is twelve months rather than six months.

Under the proposed treaty, the following activities are deemed not to constitute a permanent establishment: (1) the use of facilities solely for storing, displaying, or delivering goods or merchandise belonging to the enterprise; (2) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for storage, display, or delivery or solely for processing by another enterprise; (3) the maintenance of a fixed place of business solely for the purchase of goods or merchandise or for the collection of information for the enterprise; and (4) 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.

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

Under the proposed treaty, if a person, other than an independent agent, is acting in a treaty country on behalf of an enterprise of the other country and has, and habitually exercises, the authority to conclude contracts in the name of such enterprise, the enterprise is deemed to have a permanent establishment in the first country in respect of any activities undertaken for that enterprise. This rule does not apply where the contracting authority is limited to the activities listed above, such as storage, display, or delivery of merchandise, which are excluded from the definition of a permanent establishment.

Under the proposed treaty, no permanent establishment is deemed to arise if the agent is a broker, general commission agent, or any other agent of independent status, provided that the agent is acting in the ordinary course of its business. However, an agent will not be considered as independent if its activities are devoted wholly or almost wholly on behalf of an enterprise and the conditions between the agent and the enterprise differ from those which would be made between independent persons (*i.e.*, the agent and the enterprise are not operating at arms length). In such a case, the rules in the preceding paragraph will apply. The Technical Explanation states that whether an enterprise and an agent are independent is a factual determination, a relevant factor of which includes the extent to which the agent bears business risk.

The proposed treaty provides that the fact that a company that is a resident of one country controls or is controlled by a company that is a resident of the other country or that engages in business in the other country (whether through a permanent establishment or otherwise) does not of itself cause either company to be a permanent establishment of the other.

Article 6. Income From Immovable (Real) Property

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

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

The term "immovable (real) property" has the meaning which it has under the law of the country in which the property in question is situated. In the case of the United States, the term "real property" is defined in Treas. Reg. sec. 1.897–1(b). The proposed treaty specifies that the term in any case includes property accessory to immovable (real) property; livestock and equipment used in agriculture and forestry; rights to which the provisions of general law respecting landed property apply; any option or similar right to acquire immovable (real) property; usufruct of immovable (real) property; and rights to variable or fixed payments relating to the production from, or the right to work, mineral deposits, sources, and other natural resources. Ships, boats, and aircraft are not considered to be immovable (real) property.

The proposed treaty further provides that immovable (real) property includes rights to assets to be produced by the exploration or exploitation of the sea bed and sub-soil and their natural resources in the treaty country, including rights to interests in, or to the benefits of, such assets.

The proposed treaty specifies that the country in which the property is situated also may tax income derived from the direct use, letting, or use in any other form of immovable (real) property. The rules of Article 6, permitting source country taxation, also apply to the income from immovable (real) property of an enterprise and to income from immovable (real) property used for the performance of independent personal services.

Where the ownership of shares or other corporate rights in a company entitles the owner to the enjoyment of immovable (real) property held by the company, any income from the direct use, letting, or use in any other form of this right of enjoyment may be taxed in the treaty country in which the immovable (real) property is situated. The Technical Explanation states that this rule is intended to clarify that such income is to be treated as income from immovable (real) property and not as income from movable property, and will likely apply to a shareholder of an apartment rental cooperative.

The proposed treaty provides that residents of a treaty country that are liable for tax in the other treaty country on income from immovable (real) property situated in such other treaty country may elect to compute the tax on such income on a net basis. In the case of the U.S. tax, such an election will be binding for the taxable year of the election and all subsequent taxable years unless the competent authority of the United States agrees to terminate the election. U.S. internal law provides such a net-basis election in the case of income of a foreign person from U.S. real property (Code secs. 871(d) and 882(d)).

Article 7. Business Profits

Internal taxation rules

United States

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

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

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

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

Latvia

Nonresident individuals and corporations that have a Latvian permanent establishment are subject to tax on income derived by the permanent establishment in Latvia as well as foreign income independently derived by the permanent establishment. Income derived by a nonresident company from non-Latvian business activities that are similar to the activities of a Latvian permanent establishment (or Latvian subsidiary) may be taxed in Latvia. Business income derived in Latvia by a foreign corporation or nonresident individual generally is taxed in the same manner as the income of a Latvian corporation or resident individual.

Proposed treaty limitations on internal law

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

Under certain circumstances, the business profits of an enterprise of one country may be taxable in the other country even though the permanent establishment was not involved in the generation of such profits if two conditions are met. First, the profits must be derived either from the sale of goods or merchandise of the same or similar kind as those sold through the permanent establishment or from other business activities of the same or similar kind as those effected through the permanent establishment. Second, it must be established that the sale or activities were structured in a manner intended to avoid taxation in the country in which the permanent establishment is located. Taxation by the source country of this category of profits represents a limited force of attraction rule that is similar to, but narrower than, the rules found in the U.N. model and Code section 864(c)(3). The intent of the provision is to permit the source country to tax the income derived from sales or other business activities within its borders by the home office of the enterprise if such sales or activities are the same as or similar to sales or activities conducted there by the permanent establishment. Such profits may not be taxed by the source country, however, unless it is established that the transactions were structured to avoid such tax.

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

The proposed treaty provides that there will be attributed to a permanent establishment the business profits which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions. The Technical Explanation states that this rule permits the use of methods other than separate accounting to estimate the arm's-length profits of a permanent establishment where it is necessary to do so for practical reasons, such as when the affairs of the permanent establishment are so closely bound up with those of the head office that it would be impossible to disentangle them on any strict basis of accounts.

In computing taxable business profits, the proposed treaty provides that deductions are allowed for expenses, wherever incurred, which are incurred for the purposes of the permanent establishment. These deductions include a reasonable allocation of research and development expenses, interest, and other similar expenses and executive and general administrative expenses. The Technical Explanation states that this rule permits (but does not require) each treaty country to apply the type of expense allocation rules provided by U.S. law (such as in Treas. Reg. secs. 1.861–8 and 1.882–5).

The Technical Explanation clarifies that deductions will not be allowed for expenses charged to a permanent establishment by another unit of the enterprise. Thus, a permanent establishment may not deduct a royalty deemed paid to the head office.

Unlike the U.S. model or the OECD model, the proposed treaty allows each treaty country, consistent with its internal law, to impose limitations on the deductions taken by the permanent establishment as long as the limitations are consistent with the concept of net income (*e.g.*, partially disallowed entertainment expenses).

In cases where the information available to the competent authority is not adequate to measure accurately the profits of a permanent establishment, the tax authorities of a treaty country may apply the provisions of their internal law in determining the tax liability of such permanent establishment. This rule applies provided that, on the basis of available information, the determination of the profits of the permanent establishment is consistent with the principles of this article.

Business profits are not attributed to a permanent establishment merely by reason of the purchase of goods or merchandise by the permanent establishment for the enterprise. Thus, where a 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 a profit element in its purchasing activities.

The proposed treaty requires the determination of business profits of a permanent establishment to be made in accordance with the same method year by year unless a good and sufficient reason to the contrary exists. For purposes of the proposed treaty, the term "business profits" means profits derived from any trade or business, including profits from manufacturing, mercantile, fishing, transportation, communications, or extractive activities. Also included are profits from the furnishing of personal services of another person, including the furnishing by a company of the personal services of its employees. Business profits, however, do not include income received by an individual for his performance of personal services either as an employee or in an independent capacity.

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

The proposed treaty provides that, for purposes of the taxation of business profits, income may be attributable to a permanent establishment (and therefore may be taxable in the source country) even if the payment of such income is deferred until after the permanent establishment or fixed base has ceased to exist. This rule incorporates into the proposed treaty the rule of Code section 864(c)(6) described above. This rule applies with respect to business profits (Article 7, paragraphs 1 and 2), dividends (Article 10, paragraph 4), interest (Article 11, paragraph 5), royalties (Article 12, paragraph 4), capital gains (Article 13, paragraph 3), independent personal services income (Article 14), and other income (Article 22, paragraph 2).

Article 8. Shipping and Air Transport

Article 8 of the proposed treaty covers income from the operation or rental of ships, aircraft, and containers in international traffic. The rules governing income from the disposition of ships, aircraft, and containers are in Article 13 (Capital Gains).

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

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

For purposes of the proposed treaty, shipping profits subject to the rule described in the foregoing paragraph include profits derived from the rental of ships or aircraft on a full (time or voyage) basis (*i.e.*, with crew). It also includes profits from the rental of ships or aircraft on a bareboat basis (*i.e.*, without crew) by an enterprise engaged in the operation of ships or aircraft in international traffic, if such rental activities are incidental to the activities from the operation of ships or aircraft in international traffic. The Technical Explanation states that such rental profits from bareboat leasing that are not incidental to the operation of ships or aircraft in international traffic are treated as royalties (Article 12) or as business profits (Article 7). Profits derived by an enterprise from the inland transport of property or passengers within either treaty country are treated as profits from the operation of ships or aircraft in international traffic if such transport is undertaken as part of international traffic by the enterprise.

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

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

The Technical Explanation states that certain non-transport activities that are an integral part of the services performed by a transport company are understood to be covered by this article of the proposed treaty.

Article 9. Associated Enterprises

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

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

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

This article does not replace the internal law provisions that permit adjustments between related parties when necessary in order to prevent evasion of taxes or clearly to reflect the income. Adjustments are permitted under internal law provisions even if such adjustments are different from, or go beyond, the adjustments authorized by this article, provided that such adjustments are consistent with the general principles of this article permitting adjustments to reflect arm's-length terms.

Article 10. Dividends

Internal taxation rules

United States

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

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

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

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

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

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

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

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

Latvia

Latvia generally imposes a withholding tax on dividend payments to nonresidents at a rate of 10 percent. Latvia does not impose a withholding tax with respect to earnings of a Latvian branch of a nonresident corporation.

Proposed treaty limitations on internal law

Under the proposed treaty, dividends paid by a resident of a treaty country to a resident of the other country may be taxed in such other country. Dividends paid by a resident of a treaty country and beneficially owned by a resident of the other country may also be taxed by the country in which the payor is resident, but the rate of such tax is limited. Under the proposed treaty, source country taxation (*i.e.*, taxation by the country in which the payor is resident) generally is limited to 5 percent of the gross amount of the dividend if the beneficial owner of the dividend is a company which owns at least 10 percent of the voting shares of the payor company. The source country dividend withholding tax generally is limited to 15 percent of the gross amount of the dividends beneficially owned by residents of the other country in all other cases. The proposed treaty provides that these rules do not affect the taxation of the paying company on the profits out of which the dividends are paid.

Under the proposed treaty, dividends paid by a U.S. RIC are eligible only for the limitation that applies the 15-percent rate, regardless of the beneficial owner's percentage ownership in such entity. Dividends paid by a U.S. REIT are not eligible for the 5-percent rate. Moreover, such REIT dividends are eligible for the 15-percent rate only if the dividend is beneficially owned by an individual who holds less than a 10-percent interest in the U.S. REIT. Otherwise, dividends paid by a U.S. REIT are subject to U.S. taxation at the full 30-percent statutory rate.

The proposed treaty defines a "dividend" to include income from shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subject to the same taxation treatment as income from shares by the internal laws of the treaty country of which the company making the distribution is a resident. The term further includes income from arrangements, including debt obligations, carrying the right to participate in profits, to the extent so characterized under the law of the treaty country in which the income arises.

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

The proposed treaty permits the imposition of a branch profits tax, but limits the rate of such tax to 5 percent. The branch profits tax may be imposed on a company that is a resident of a treaty country and has a permanent establishment in the other treaty country or is subject to tax in the other treaty country on a net basis on its income from immovable (real) property (Article 6) or capital gains (Article 13). Such tax may be imposed only on the portion of the business profits attributable to such permanent establishment, or the portion of such immovable (real) property income or capital gains, that represents the "dividend equivalent amount." The Technical Explanation states that the term "dividend equivalent amount" has the same meaning that it has under Code section 884, as amended from time to time, provided the amendments are consistent with the purpose of the branch profits tax.

Where a treaty country resident derives profits or income from the other treaty country, the proposed treaty provides that such other country cannot impose any tax on the dividends paid by such resident. Thus, the United States cannot impose its "secondary" withholding tax on dividends paid by a Latvian company out of its earnings and profits from the United States. An exception to this provision is provided in cases where the dividends are paid to a resident of the other treaty country or are attributable to a permanent establishment or a fixed base situated in such other treaty country (even if the dividends paid consist wholly or partly of profits arising in such other country).

Article 11. Interest

Internal taxation rules

United States

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

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

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

Latvia

Latvia generally imposes a withholding tax on interest paid to associated nonresident individuals and corporations at a rate of 10 percent. However, the rate is 5 percent for interest paid by Latvian registered banks. Interest paid to non-associated nonresidents are not subject to withholding tax.

Proposed treaty limitations on internal law

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

The proposed treaty limits the rate of source country tax that may be imposed on interest income. Under the proposed treaty, if the beneficial owner of interest is a resident of the other country, the source country tax on such interest generally may not exceed 10 percent of the gross amount of such interest. This rate is higher than the U.S. model rate, which is zero.

The proposed treaty provides for a complete exemption from source country withholding tax in the case of interest arising in a treaty country and (1) derived and beneficially owned by the Government of the other treaty country, including political subdivisions and local authorities thereof, (2) derived and beneficially owned by the Central Bank or any financial institution wholly owned by the Government, or (3) derived on loans guaranteed or insured by the Government, subdivision, authority, or institution. The Technical Explanation states that the second exemption refers to the Central Bank of Latvia or any Federal Reserve Bank of the United States and that the third exemption refers to loans guaranteed or insured by the U.S. Export-Import Bank and the Overseas Private Investment Corporation. A further complete exemption from source country withholding applies to interest beneficially owned by an enterprise of a treaty country that is paid with respect to indebtedness arising as a consequence of the sale on credit by an enterprise of the other treaty country of any merchandise, or industrial, commercial, or scientific equipment to an enterprise of the first treaty country, except where the sale on credit is between related persons.

The proposed treaty provides two anti-abuse exceptions to the general source-country reduction in tax discussed above. The first exception relates to "contingent interest" payments. If interest is paid by a source-country resident to a resident of the other country and is determined by reference to (1) the receipts, sales, income, profits, or the cash flow of the debtor or a related person, (2) any change in the value of any property of the debtor or a related person, or (3) to any dividend, partnership distribution or similar payment made by the debtor to a related person, such interest may be taxed in the source country in accordance with its internal laws. However, if the beneficial owner is a resident of the other country, such interest may not be taxed at a rate exceeding 15 percent (*i.e.*, the rate prescribed in paragraph 2(b) of Article 10 (Dividends)). The second anti-abuse exception provides that the reduction in and exemption from source country tax do not apply to excess inclusions with respect to a residual interest in a U.S. REMIC. Such income may be taxed in accordance with U.S. domestic law.

The proposed treaty defines the term “interest” as income from debt claims of every kind, whether or not secured by a mortgage and whether or not carrying a right to participate in the debtor’s profits. In particular, it includes income from government securities and from bonds or debentures, including premiums or prizes attaching to such securities, bonds, or debentures. The proposed treaty includes in the definition of interest any other income that is treated as interest by the domestic law of the country in which the income arises. Penalty charges for late payment are not regarded as interest for purposes of this article. The proposed treaty provides that the term “interest” does not include amounts treated as dividends under Article 10 (Dividends).

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

The proposed treaty provides that interest is treated as arising in a treaty country if the payor is a resident of that country.[4] If, however, the interest expense is borne by a permanent establishment or a fixed base, the interest will have as its source the country in which the permanent establishment or fixed base is located, regardless of the residence of the payor. Thus, for example, if a French resident has a permanent establishment in Latvia and that French resident incurs indebtedness to a U.S. person, the interest on which is borne by the Latvian permanent establishment, the interest would be treated as having its source in Latvia.

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

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

The proposed treaty permits the United States to impose its branch level interest tax on a Latvian corporation. The base of this tax is the excess, if any, of (1) the interest deductible in computing the profits of the corporation that are subject to tax and either attributable to a permanent establishment or subject to tax under Article 6 (Income From Immovable (Real) Property) or Article 13 (Capital Gains) over (2) the interest paid by or from the permanent establishment or trade or business. Such excess interest will be deemed to arise in the United States and be beneficially owned by the Latvian corporation for purposes of applying the reduced withholding rates under this article.

Article 12. Royalties

Internal taxation rules

United States

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

Latvia

Latvia generally imposes a 15 percent withholding tax on royalties paid to nonresidents, and derived from the right to use copyrights on works of literature or art, including films, videos, and other recordings. However, the withholding tax rate is reduced to 5 percent for royalties paid to nonresidents when derived from other kinds of intellectual property.

Proposed treaty limitations on internal law

The proposed treaty provides that royalties arising in a treaty country and beneficially owned by a resident of the other country may be taxed by that other country. In addition, the proposed treaty allows the country where the royalties arise (the "source country") to tax such royalties. However, if the beneficial owner of the royalties is a resident of the other country, the source country tax generally may not exceed 10 percent of the gross royalties. This 10-percent rate is higher than the rate permitted under most U.S. treaties and the U.S. and OECD models. The U.S. and OECD models generally exempt royalties from source country taxation. The proposed treaty further provides that the source country tax on certain amounts treated as royalties may not exceed 5 percent of the gross royalties. This 5-percent limitation applies to payments of any kind in consideration for the use of industrial, commercial, or scientific equipment.

For purposes of the proposed treaty, the term "royalties" means payments of any kind received as consideration for the use of, the right to use, or the sale (which is contingent on the productivity, use, or further disposition) of any copyright of literary, artistic, or scientific work (including computer software, cinematographic films and films or tapes and other means of image or sound reproduction for radio or television broadcasting), patent, trademark, design or model, plan, secret formula, or process. The term also includes consideration for the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial, or scientific experience. According to the Technical Explanation, it is understood that whether payments with respect to computer software are treated as royalties or as business profits will depend on the facts and circumstances of the particular transaction. The Technical Explanation also states that it is understood that payments with respect to transfers of "shrink wrap" computer software will be treated as business profits.

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

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

The proposed treaty provides source rules for royalties which differ, in part, from those provided under U.S. internal law. Royalties are deemed to arise within a country if the payor is a resident of that country. If, however, the royalty expense is borne by a permanent establishment or fixed base that the payor has in Latvia or the United States, the royalty has as its source the country in which the permanent establishment or fixed base is located, regardless of the residence of the payor. Thus, for example, if a French resident has a permanent establishment in Latvia and that French resident pays a royalty to a U.S. person which is attributable to the Latvian permanent establishment, then the royalty would be treated as having its source in Latvia. In addition, the proposed treaty provides that where the preceding rules do not operate to deem royalties as arising in either the United States or Latvia, and the royalties relate to the use of, or the right to use, a right or property in one of those countries, the royalties are deemed to arise in that country and not in the country of which the payor is resident.

Finally, notwithstanding the sourcing rules above, payments received for the use of containers (including trailers, barges, and related equipment for the transport of containers) used in the transportation of passengers or property (other than transportation solely between places in the same treaty country) and not dealt with in Article 8 (Shipping and Air Transport) will be deemed to arise in neither treaty country.

Article 13. Capital Gains

Internal taxation rules

United States

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

Latvia

Gains derived by nonresidents on the sale of securities in Latvia are subject to a 10 percent withholding tax. Gains from the sale of Latvian real estate by nonresidents are subject to a 25 percent withholding tax.

Proposed treaty limitations on internal law

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

Under the proposed treaty, gains derived by a resident of one treaty country from the alienation of immovable (real) property situated in the other country may be taxed in the country where the property is situated. For the purposes of this article, immovable (real) property in the other country includes (1) immovable (real) property as defined in Article 6 (Income from Immovable (Real) Property) situated in the other country, (2) shares of stock of a company the property of which consists at least 50 percent of immovable (real) property situated in the other country, and (3) an interest in a partnership, trust, or estate, to the extent that its assets consist of immovable (real) property situated in the other country. In the United States, the term includes a "United States real property interest."

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

Gains derived by an enterprise of a treaty country from the alienation of ships, aircraft, or containers operated in international traffic (or movable property pertaining to the operation or use of ships, aircraft, or containers) are taxable only in such country.

Payments that satisfy the definition of royalties are taxable under the proposed treaty only in accordance with Article 12 (Royalties). The Technical Explanation states that this rule makes clear that this article does not apply to gains from the sale of any right or property that would give rise to royalties, to the extent that such gains are contingent on the productivity, use, or further disposition thereof.

Gains from the alienation of any property other than that discussed above is taxable under the proposed treaty only in the country where the person disposing of the property is resident.

Article 14. Independent Personal Services

Internal taxation rules

United States

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

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

Latvia

Management and consultancy fees paid to nonresidents are subject to a withholding tax at a rate of 10 percent levied on the gross amount. All other payments for personal services are subject to the normal withholding tax rate of 25 percent.

Proposed treaty limitations on internal law

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

Under the proposed treaty, income in respect of professional services or other activities of an independent character performed in one country by a resident of the other country is exempt from tax in the country where the services are performed (the source country) unless the individual performing the services has a fixed base regularly available to him or her in that country for the purpose of performing the services.[5] In that case, the source country is permitted to tax only that portion of the individual's income which is attributable to the fixed base. This rule also applies where the income is received after the fixed base is no longer in existence. An individual will be deemed to have a fixed base regularly available in the other country if he or she stays in the source country for a period or periods exceeding 183 days within a 12-month period, commencing or ending in the taxable year concerned. This latter rule represents a departure from the U.S. model, which would permit the source country to tax the income from independent personal services of a resident of the other country only if the income is attributable to a fixed base regularly available to the individual in the source country for the purpose of performing the activities.

Under the proposed treaty, income that is taxable in the other country pursuant to this article will be determined in the same way as professional services income (or other income from activities of an independent character) of a resident of the other country. However, the proposed treaty does not require a treaty country to grant to residents of the other country any personal allowances, reliefs, and reductions for taxation purposes on account of civil status or family responsibilities that it grants to its own residents.

The term "professional services" includes especially independent scientific, literary, artistic, educational, or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists, and accountants.

Article 15. Dependent Personal Services

Under the proposed treaty, wages, salaries, and other remuneration derived from services performed as an employee in one country (the source country) by a resident of the other country are taxable only by the country of residence if three requirements are met: (1) the individual must be present in the source country for not more than 183 days in any 12-month period; (2) the individual is paid by, or on behalf of, an employer who is not a resident of the source country; and (3) the compensation must not be borne by a permanent establishment or fixed base of the employer in the source country. These limitations on source country taxation are the same as the rules of the U.S. model and the OECD model.

The proposed treaty contains a special rule that permits remuneration derived by a resident of one country in respect of employment as a member of the regular complement (including the crew) of a ship or aircraft operated in international traffic by an enterprise of the other country to be taxed in that other country. A simi-

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

lar rule is included in the OECD model. U.S. internal law does not impose tax on such income of a nonresident alien, even if such person is employed by a U.S. entity.

This article is subject to the provisions of the separate articles covering directors' fees (Article 16), pensions, social security, annuities, alimony, and child support (Article 18), government service income (Article 19), and income of students, trainees, and researchers (Article 20).

Article 16. Directors' Fees

Under the proposed treaty, directors' fees and other compensation derived by a resident of one country in his or her capacity as a member of the board of directors (or any similar organ) of a company that is a resident of that other country is taxable in that other country. The provision is similar to the corresponding rule in the OECD model. Under this rule, the country in which the company is resident may tax all of the remuneration paid to nonresident board members, regardless of where the services are performed. The U.S. model contains a different rule, which provides that the country of the company's residence may tax nonresident directors, but only with respect to remuneration for services performed in that country.

Article 17. Artistes and Sportsmen

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

Under the proposed treaty, income derived by an entertainer or sportsman who is a resident of one country from his or her personal activities as such in the other country may be taxed in the other country if the amount of the gross receipts derived by him or her from such activities exceeds $20,000 or its equivalent in Latvian lats. The $20,000 threshold includes reimbursed expenses. Under this rule, if a Latvian entertainer or sportsman maintains no fixed base in the United States and performs (as an independent contractor) for one day of a taxable year in the United States for total compensation of $10,000, the United States could not tax that income. If, however, that entertainer's or sportsman's total compensation were $30,000, the full amount would be subject to U.S. tax.

The proposed treaty provides that where income in respect of activities exercised by an entertainer or sportsman in his or her capacity as such accrues not to the entertainer or sportsman but to another person, that income is taxable by the country in which the activities are exercised unless it is established that neither the entertainer or sportsman nor persons related to him or her participated directly or indirectly in the profits of that other person in any manner, including the receipt of deferred remuneration, bonuses, fees, dividends, partnership distributions, or other distributions. This provision applies notwithstanding the business profits and personal service articles (Articles 7, 14, and 15). This provision prevents highly-paid entertainers and athletes from avoiding tax in the country in which they perform by, for example, routing the compensation for their services through a third entity such as a personal holding company or a trust located in a country that would not tax the income.

The proposed treaty provides that these rules do not apply to income derived from activities performed in a country by entertainers or sportsmen if such activities are wholly or mainly supported by public funds of the other country or a political subdivision or a local authority thereof. In such a case, the income is taxable only in the country in which the entertainer or sportsman is a resident.

Article 18. Pensions, Social Security, Annuities, Alimony, and Child Support

Under the proposed treaty, pensions and other similar remuneration derived and beneficially owned by a resident of either country in consideration of past employment, whether paid periodically or in a lump sum, is subject to tax only in the recipient's country of residence. However, the amount of any such pension or remuneration that would be excluded from taxable income in the other country if the recipient were a resident thereof will be exempt from taxation in the first-mentioned country of residence. These rules are subject to the provisions of Article 19 (Government Service) with respect to pensions.

The proposed treaty provides that payments made by one of the countries under the provisions of the social security or similar legislation of the country to a resident of the other country or to a U.S. citizen are taxable only by the source country, and not by the country of residence. The Technical Explanation states that the term "similar legislation" is intended to include U.S. tier 1 Railroad Retirement benefits. Consistent with the U.S. model, this rule with respect to social security payments is an exception to the proposed treaty's saving clause.

The proposed treaty provides that annuities are taxed only in the country of residence of the individual who beneficially owns and derives them. The term "annuities" is defined for purposes of this provision as a stated sum (other than a pension) paid periodically at stated times during a specified number of years, under an obligation to make the payments in return for adequate and full consideration (other than services rendered).

Under the proposed treaty, alimony paid by a resident of one country, and deductible therein, to a resident of the other country will be taxable only in the other country. For this purpose, the term "alimony" means periodic payments made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support, which payments are taxable to the recipient under the laws of the country of residence. However, periodic payments (other than alimony) for the support of a minor child made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support, paid by a resident of one country to a resident of the other country, are not taxable in the other country.

Article 19. Government Service

Under the proposed treaty, remuneration, other than a pension, paid by, or out of the public funds of a treaty country or a political subdivision or local authority thereof to an individual in respect of dependent personal services rendered to that country (or subdivision or authority) in the discharge of functions of a governmental nature generally is taxable only by that country. Such remuneration is taxable only in the other country, however, if the services are rendered in that other country by an individual who is a resident of that country and who (1) is also a national of that country or (2) did not become a resident of that country solely for the purpose of rendering the services. This treatment is similar to the rules under the U.S. and OECD models.

The proposed treaty further provides that any pension paid by, or out of the public funds of one of the countries (or a political subdivision or local authority thereof) to an individual in respect of services rendered to that country (or subdivision or authority) in the discharge of functions of a governmental nature is taxable only by that country. Such a pension is taxable only by the other country, however, if the individual is a resident and national of that other country. Social security benefits in respect of government services are subject to Article 18 (Pensions, Social Security, Annuities, Alimony, and Child Support) and not this article. This treatment is similar to the OECD model, but differs from the U.S. model, in that it applies only to government employees and not to independent contractors engaged by governments to perform services for them.

The Technical Explanation states that the phrase "functions of a governmental nature" is generally understood to encompass functions traditionally carried on by a government. It generally would not include functions that commonly are found in the private sector (*e.g.*, education, health care, utilities). Rather, it is limited to functions that generally are carried on solely by the government (*e.g.*, military, diplomatic service, tax administrators) and activities that directly support the carrying out of those functions.

The provisions described in the foregoing paragraphs are exceptions to the proposed treaty's saving clause for individuals who are neither citizens nor permanent residents of the country where the services are performed. Thus, for example, a resident of Latvia, who in the course of performing functions of a governmental nature becomes a resident of the United States (but not a permanent resident), would be entitled to the benefits of this article. However, an individual who receives a pension paid by the Government of Latvia in respect of services rendered to that Government is taxable on that pension only in Latvia unless the individual is a U.S. citizen or acquires a U.S. green card.

Article 20. Students, Trainees and Researchers

Under the proposed treaty, a resident of one country who visits the other country (the host country) for the primary purpose of studying at a university or other accredited educational institution, securing training in a professional specialty, or studying or doing research as the recipient of a grant from a governmental, religious, charitable, scientific, literary, or educational organization will be exempt from tax in the host country with respect to certain items of income for a period not exceeding five years from the date of arrival in the host country. The items of income that are eligible for exemption from host country taxation are: (1) payments from abroad for maintenance, education, study, research, or training; (2) grants, allowances, or awards; and (3) income from personal services performed in the other country to the extent of $5,000, or its equivalent in Latvian lats.

Under the proposed treaty, an individual resident of one country who visits the other country as an employee of, or under contract with, a resident of the first country for the primary purpose of acquiring technical, professional, or business experience from a person other than his employer or studying at a university or other accredited educational institution in the other country is exempt from tax by the other country for a period of 12 consecutive months on compensation for personal services in an aggregate amount not exceeding $8,000 or its equivalent in Latvian lats.

Under the proposed treaty, an individual resident of one country who is temporarily present in the other country for a period not exceeding one year, as a participant in a program sponsored by the Government of the other country, for the primary purpose of training, research, or study is exempt from tax by the other country on compensation for personal services performed in the other country in respect of such training, research, or study, in an aggregate amount not exceeding $10,000 or its equivalent in Latvian lats.

The proposed treaty provides that this article does not apply to income from research undertaken not in the public interest, but primarily for the private benefit of a specific person or persons.

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

Article 21. Offshore Activities

Under the proposed treaty, a resident of a treaty country that carries on activities offshore in the other country in connection with the exploration or exploitation of the sea bed and sub-soil and their natural resources will be deemed, in relation to such activities, to be carrying on business in the other country through a permanent establishment or a fixed base situated therein. This provision applies, notwithstanding the provisions of Articles 4 through 20. This provision only applies when offshore activities are carried on by a resident (and certain associated persons) in the other country for a period or periods aggregating more than 30 days in any 12-month period. For this purpose, if two associated persons are carrying on substantially the same offshore activities at different times, each activity of an associated person will be regarded as being carried on by the other. Persons are associated if one is controlled (directly or indirectly) by the other, or both are controlled (directly or indirectly) by a third person or persons.

The proposed treaty specifically excludes from the application of this article the following activities: (1) one or any combination of the activities deemed not to constitute a permanent establishment (as described in paragraph 4 of Article 5 (Permanent Establishment)); (2) towing or anchor handling by ships primarily designed for such purpose and any other activities performed by such ships; or (3) the transport of supplies or personnel by ships or aircraft in international traffic.

Under the proposed treaty, wages and similar remuneration derived by a resident of one country in respect of an employment connected with the exploration or exploitation of the sea bed and subsoil (and their natural resources) situated in the other country, to the extent performed offshore in the other country, may be taxed in the other country. However, such remuneration is taxable only by the first country (*i.e.*, the employee's country of residence) if the employment is carried on offshore for an employer who is not a resident of the other country and for a period or periods not exceeding, in the aggregate, 30 days in any 12-month period.

The proposed treaty further provides that salaries, wages, and similar remuneration derived by a resident of one country in respect of an employment exercised aboard a ship or aircraft engaged in the transportation of supplies or personnel to a location, or between locations, where sea bed and sub-soil (and their natural resources) exploration or exploitation activities are being carried on in the other country, or in respect of an employment exercised aboard tugboats or other vessels operated auxiliary to such activities, may be taxed in the country of which the employer is a resident.

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 Latvia. As a general rule, items of income not otherwise dealt with in the proposed treaty which are beneficially owned by residents of one of the countries, wherever arising, are taxable only in the country of residence. This rule is similar to the rules in the U.S. and OECD models.

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

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

Article 23. Limitation on Benefits

In general

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

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

The proposed anti-treaty shopping article provides that a resident of either Latvia or the United States will be entitled to the benefits of the proposed treaty only if the resident is a "qualified resident." A resident is a qualified resident for a taxable year only if it:

(1) is an individual;

(2) is a treaty country, a political subdivision or a local authority thereof, or an agency or instrumentality of such country, subdivision, or authority;

(3) is a company, trust, or estate that satisfies both aspects of an ownership and base erosion test;

(4) is a person that satisfies a public company test;

(5) is a person that is owned by certain public companies;

(6) is a tax-exempt organization or pension fund that satisfies an ownership test; or

(7) is a United States regulated investment company, or a similar entity in Latvia as may be agreed by the competent authorities of the treaty countries.

Alternatively, a resident that is not a qualified resident may claim treaty benefits for particular items of income if it satisfies an active business test. In addition, a resident of either country that is not a qualified resident may be entitled to the benefits of the proposed treaty if the competent authority of the country in which the income in question arises so determines.

Individuals

An individual resident of a treaty country is entitled to the benefits of the proposed treaty.

Governments

Under the proposed treaty, the two countries, their political subdivisions or local authorities, or agencies or instrumentalities of the countries or their political subdivisions or local authorities, are entitled to all treaty benefits.

Ownership and base erosion test

Under the proposed treaty, an entity that is resident in one of the countries is entitled to treaty benefits if it satisfies an ownership test and a base erosion test. For this purpose, an entity includes a company, as well as a trust or an estate. Under the ownership test, at least 50 percent of the beneficial interests in an entity (in the case of a company, at least 50 percent of each class of the company's shares) must be beneficially owned, directly or indirectly, on at least half the days of the taxable year by qualified residents (as described above) or U.S. citizens, provided that each intermediate owner used to satify the control requirement is a resident of Latvia or the United States. This rule could, for example, deny the benefits of the reduced U.S. withholding tax rates on dividends and royalties paid to a Latvian company that is controlled by individual residents of a third country.

In addition, the base erosion test is satisfied only if no more than 50 percent of the gross income of the company (or the payments in the case of a trust or estate) is paid or accrued during the taxable year to persons (1) that are neither qualified residents nor U.S. citizens, and (2) that are deductible for income tax purposes in the entity's country of residence (but not including arm's length payments in the ordinary course of business for services or tangible property). This rule is intended to prevent an entity from distributing most of its income, in the form of deductible items such as interest, royalties, service fees, or other amounts to persons not entitled to benefits under the proposed treaty.

Public company tests

The public company test is satisfied if at least 50 percent of the value of each class of the beneficial interests in a person are substantially and regularly traded on a recognized stock exchange. Similarly, treaty benefits are available to a person that is at least 50-percent owned, directly or indirectly, by a person that satisfies the public company previously described, provided that each intermediate owner used to satisfy the control requirement is a resident of Latvia or the United States.

The Technical Explanation states that interests are considered to be "substantially and regularly traded" if two requirements are met: trades in the class of interests are made in more than de minimis quantities on at least 60 days during the taxable year, and the aggregate number of interests in the class traded during the year is at least 6 percent of the average number of interests outstanding during the year.

Under the proposed treaty, the term "recognized stock exchange" means: (1) the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934; (2) the Riga stock exchange (Rigas Fondu Birza) and any other stock exchanges approved by the State authorities; and (3) any other stock exchange agreed upon by the competent authorities of the countries.

Tax-exempt entities

A legal person organized under the laws of either treaty country and that is generally exempt from tax in that country is entitled to the benefits of the proposed treaty if it is established and maintained in a treaty country either exclusively for a religious, charitable, educational, scientific, or other similar purpose; or to provide pensions or other similar benefits to employees pursuant to a plan. In addition, more than half of the beneficiaries, members, or participants, if any, in such person must be qualified residents.

Regulated investment companies

A United States regulated investment company, or a similar entity in Latvia as may be agreed by the competent authorities of the treaty countries, is entitled to the benefits of the proposed treaty.

Active business test

Under the active business test, treaty benefits are available to a resident of a country with respect to an item of income derived from the other country if: (1) the resident is engaged in the active conduct of a trade or business in the country of residence; (2) the income is connected with or incidental to that trade or business; and (3) the trade or business is substantial in relation to the activity in the other country generating the income. However, the business of making or managing investments does not constitute an active trade or business (and benefits therefore may be denied), unless such activity is a banking, insurance, or securities activity conducted by a bank, insurance company, or registered securities dealer.

The determination of whether a trade or business is substantial is determined based on all facts and circumstances. However, the proposed treaty provides a safe harbor under which the trade or business of the resident 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. To satisfy the safe harbor, the level of each such attribute in the active conduct of the trade or business by the resident (and any related parties) 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 or for the prior three years. 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, for the prior year or for the average of the three prior years, the average of the three ratios exceeds 10 percent, and each ratio separately is at least 7.5 percent. These rules are similar to those contained in the U.S. model. The Technical Explanation states that 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.

The proposed treaty provides that income is derived in connection with a trade or business if the activity in the other country generating the income is a line of business that forms a part of or is complementary to the trade or business. The Technical Explanation states that a business activity generally is considered to "form a part of" a business activity conducted in the other country if the two activities involve the design, manufacture, or sale of the same products or type of products, or the provision of similar services. The Technical Explanation further provides that in order for two activities to be considered to be "complementary," the activities need not relate to the same types of products or services, but they should be part of the same overall industry and be related in the sense that the success or failure of one activity will tend to result in success or failure for the other. Under the proposed treaty, income is incidental to a trade or business if it facilitates the conduct of the trade or business in the other country.

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

Other matters

Under the proposed treaty, the competent authorities of the treaty countries will consult together with a view to developing a commonly agreed application of the provisions of this article, including the publication of public guidance. The competent authorities will, in accordance with the provisions of Article 27 (Exchange of Information and Administrative Assistance), exchange such information as is necessary for carrying out the provisions of this article.

Article 24. Relief From Double Taxation

Internal taxation rules

United States

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

Latvia

Latvian resident individuals and companies receive a foreign tax credit for foreign taxes, not to exceed the amount of Latvian tax on such income. The limitation is calculated on a per country basis. In the absence of a specific treaty exception, foreign tax credit relief is only granted for withholding taxes paid with respect to foreign-source dividends and not for the underlying corporate taxes.

Proposed treaty limitations on internal law

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

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

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

The proposed treaty generally provides that, unless domestic law grants a more favorable treatment, Latvia will allow its residents, who derive income that may be subject to tax in the United States and Latvia, a deduction against Latvian income tax for the U.S. incomes taxes paid (other than any such tax imposed by reason of U.S. citizenship). The deduction cannot exceed the pre-credit amount of Latvian income tax attributable to the income that may be taxed in the United States. For purposes of this rule, the amount of tax available for deduction includes the appropriate portion of the taxes paid in the United States on the underlying profits of the company out of which the dividend is paid, but only when the Latvian resident receives the dividend from a U.S. resident company in which it owns at least 10 percent of the voting power.

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

Article 25. Nondiscrimination

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 included in other recent U.S. income tax treaties.

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, in particular with respect to residence. This rule applies whether or not the nationals in question are residents of the United States or Latvia. However, for purposes of U.S. tax, U.S. nationals subject to tax on a worldwide basis are not in the same circumstances as Latvian nationals who are not U.S. residents.

Under the proposed treaty (like the OECD model), a "stateless person" who is resident of one country cannot be subjected in either country to other or more burdensome taxes (or requirements connected with taxes) than would apply to nationals of the taxing country in the same circumstances. However, for purposes of U.S. tax, U.S. nationals subject to tax on a worldwide basis are not in the same circumstances as Latvian resident stateless persons who are not U.S. residents. The Technical Explanation states that a stateless person is understood to refer to a person who is not considered as a national by any country under the operation of its law.

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

Each country is required (subject to the arm's-length pricing rules of paragraph 1 of Article 9 (Associated Enterprises), paragraph 7 of Article 11 (Interest), and paragraph 5 of Article 12 (Royalties)) to allow its residents to deduct interest, royalties, and other disbursements paid by them to residents of the other country under the same conditions that it allows deductions for such amounts paid to residents of the same country as the payor. The Technical Explanation states that the term "other disbursements" is understood to include a reasonable allocation of executive and general administrative expenses, research and development expenses, and other expenses incurred for the benefit of a group of related persons. The Technical Explanation further states that the rules of section 163(j) of the Code are not discriminatory within the meaning of this provision. The proposed treaty further provides that any debts of a resident of one country to a resident of the other country are deductible for purposes of determining the taxable capital of the debtor under the same conditions as if the debt had been owed to a resident of the country imposing such tax.

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

The proposed treaty provides that nothing in the nondiscrimination article is to be construed as preventing either of the countries from imposing a branch profits tax or a branch-level interest tax. Notwithstanding the definition of taxes covered in Article 2, this article applies to taxes of every kind and description imposed by either country, or a political subdivision or local authority thereof.

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

Article 26. Mutual Agreement Procedure

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

Under this article, a resident of one country who considers that the action of one or both of the countries will cause him or her to be subject to tax which is not in accordance with the proposed treaty may present his or her case to the competent authority of either country. The case must be presented within 3 years from the first notification of the action resulting in taxation not in accordance with the provisions of the treaty. The competent authority then makes a determination as to whether the objection appears justified. If the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, that competent authority must 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.

The competent authorities of the countries must endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the proposed treaty. In particular, the competent authorities may agree to the following: (1) the same attribution of income, deductions, credits, or allowances of an enterprise of one treaty country to the enterprise's permanent establishment situated in the other country; (2) the same allocation of income, deductions, credits, or allowances between persons; (3) the same characterization of particular items of income; (4) the same characterization of persons; (5) the same application of source rules with respect to particular items of income; (6) a common meaning of a term; (7) increases in any specific dollar amounts referred to in the proposed treaty to reflect economic or monetary developments; (8) advance pricing arrangements; and (9) the application of the provisions of each country's internal law regarding penalties, fines, and interest in a manner consistent with the purposes of the proposed treaty. The competent authorities may also consult together for the elimination of double taxation regarding cases not provided for in the proposed treaty. This treatment is similar to the treatment under the U.S. model.

The proposed treaty authorizes the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of this mutual agreement article. This provision makes clear that it is not necessary to go through diplomatic channels in order to discuss problems arising in the application of the proposed treaty.

Article 27. Exchange of Information and Administrative Assistance

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

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

Any information exchanged under the proposed treaty is treated as secret in the same manner as information obtained under the domestic laws of the country receiving the information. The exchanged information may be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes to which the proposed treaty applies. Such persons or authorities must use the information for such purposes only.[6] The Technical Explanation states that persons involved in the administration of taxes include legislative bodies with oversight roles with respect to the administration of the tax laws, such as, for example, the tax-writing committees of Congress and the General Accounting Office. Information received by these bodies must be 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.

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

Notwithstanding the preceding paragraph, a country has the authority to obtain and provide information held by financial institutions, nominees, or persons acting in a fiduciary capacity. It also has the authority to obtain information respecting ownership of debt instruments or interests in a person. Such information must be provided to the requesting country notwithstanding any laws or practices of the requested country that would otherwise preclude acquiring or disclosing such information. Furthermore, if information is requested by a treaty country pursuant to this article, the other country is obligated to obtain the requested information as if the tax in question were the tax of the requested country, even if that country has no direct tax interest in the case to which the request relates. If specifically requested, the competent authority of a country must provide information in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of the requested country with respect to its own taxes. Also, the proposed treaty provides that the competent authority of the requested country must allow representatives of the requesting country to enter the requested country to interview individuals and examine books and records with the consent of the person subject to examination.

Under the proposed treaty, a country must endeavor to collect on behalf of the other country only those amounts necessary to ensure that any exemption or reduced rate of tax at source granted under the treaty by the other country is not enjoyed by persons not entitled to such benefits. However, neither country is obligated, in the process of providing collection assistance, to carry out administrative measures that differ from those used in the collection of its own taxes, or that would be contrary to its sovereignty, security, or public policy.

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

Article 28. Members of Diplomatic Missions and Consular Posts

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

Article 29. Entry Into Force

The proposed treaty will enter into force on the date on which the second of the two notifications of the completion of ratification requirements has been received. Each country must notify the other through diplomatic channels when its constitutional requirements for ratification have been satisfied.

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

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

The proposed treaty provides that the appropriate authorities of the treaty countries will consult within 5 years from the date of the entry into force of the proposed treaty regarding its application, including the negotiation of a treaty amendment (by means of a protocol, if appropriate) regarding income derived from new technologies (such as payments received for transmission by satellite, cable, optic fibre, or similar technology).

Article 30. Termination

The proposed treaty will continue in force until terminated by either country. Either country may terminate the proposed treaty at any time at least six months before the end of any calendar year by giving written notice of termination through diplomatic channels. A termination is effective, with respect to taxes withheld at source for amounts paid or credited on or after the first day of the calendar year next following the expiration of the notification period. In the case of other taxes, a termination is effective for taxable years beginning on or after the first day of January next following the expiration of the notification period.

IV. ISSUES

The proposed treaty with Latvia presents the following specific issues.

A. Treatment of REIT Dividends

REITs in general

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

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

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

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

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

In order to satisfy the source of income requirements, at least 95 percent of the gross income of the REIT generally must be from certain passive sources (*e.g.*, dividends, interest, and rents). In addition, at least 75 percent of its gross income generally must be from certain real estate sources (*e.g.*, real property rents, mortgage interest, and real property gains).

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

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

Foreign investors in REITs

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

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

U.S. income tax treaties contain provisions limiting the amount of income tax that may be imposed by one country on residents of the other country. Many treaties, like the proposed treaty, generally allow the source country to impose not more than a 15-percent withholding tax on dividends paid to a resident of the other treaty country. In the case of real estate income, most treaties, like the proposed treaty, specify that income derived from, and gain from dispositions of, real property in one country may be taxed by the country in which the real property is situated without limitation.[7] Accordingly, U.S. real property rental income derived by a resident of a treaty partner generally is subject to the U.S. withholding tax at the full 30-percent rate (unless the net-basis taxation election is made), and U.S. real property gains of a treaty partner resident are subject to U.S. tax in the manner and at the rates applicable to U.S. persons.

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

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

Beginning in 1989, U.S. treaty negotiators began including in treaties provisions excluding REIT dividends from the reduced rates of withholding tax generally applicable to dividends. Under treaties with these provisions such as the proposed treaty, REIT dividends generally are subject to the full U.S. 30-percent withholding tax.[8]

Analysis of treaty treatment of REIT dividends

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

[7] 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.

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

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

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

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

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

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

Modification of policy regarding treaty treatment of REIT dividends

In 1997, the Treasury Department modified its policy with respect to the exclusion of REIT dividends from the reduced withholding tax rates applicable to other dividends under the treaties. The new policy was a result of significant cooperation among the Treasury Department, the staff of the Committee on Foreign Relations, the staff of the Joint Committee on Taxation, and representatives of the REIT industry. Under this policy, REIT dividends paid to a resident of a treaty country will be eligible for the reduced rate of withholding tax applicable to portfolio dividends (typically, 15 percent) in two cases. First, the reduced withholding tax will apply to REIT dividends if the treaty country resident beneficially holds an interest of 5 percent or less in each class of the REIT's stock and such dividends are paid with respect to a class of the REIT's stock that is publicly traded. Second, the reduced withholding tax rate will apply to REIT dividends if the treaty country resident beneficially holds an interest of 10 percent or less in the REIT and the REIT is diversified, regardless of whether the REIT's stock is publicly traded.[9] In addition, the current treaty policy with respect to the application of the reduced withholding tax rate to REIT dividends paid to individuals holding less than a specified interest in the REIT will remain unchanged.

In 1997, the Committee included a reservation to the U.S.-Luxembourg treaty that was submitted for ratification, requiring that such treaty incorporate this new policy with respect to the treatment of REIT dividends generally.[10] In addition, the Committee included declarations to the 1997 treaties with Austria, Ireland, and Switzerland, which stated that the United States will use its best efforts to negotiate a protocol with Austria, Ireland, and Switzerland to amend such treaties to incorporate this new policy. The Treasury Department also will incorporate this new policy with respect to the treatment of REIT dividends in the U.S. model treaty and in future treaty negotiations.

Issue

Under many older U.S. tax treaties, the U.S. withholding tax on REIT dividends paid to residents of the treaty partner is limited to a maximum rate of 15 percent. Under the proposed treaty, as under some 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 Latvia may be subject to U.S. withholding tax at the full statutory rate of 30 percent.

The Committee may wish to consider whether, in light of the competing considerations discussed above, the treatment of REIT dividends in the proposed treaty is appropriate.

B. Developing Country Concessions

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

[9] For purposes of the rules, a REIT will be considered to be diversified if the value of no single interest in real property held by the REIT exceeds 10 percent of the value of the REIT's total interests in real property.

[10] The reservation to the Luxembourg treaty also provided for a special rule for dividends on certain existing REIT investments.

Definition of permanent establishment

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

In addition, under Article 21 (Offshore Activities) of the proposed treaty, offshore activities for the exploration or exploitation of the sea bed and sub-soil and their natural resources in a country for more than 30 days in any 12-month period would cause such activities to be treated in a manner analogous to a permanent establishment. Under the U.S. model, drilling rigs or ships must be present in a country for more than one year in order to constitute a permanent establishment.

Taxation of business profits

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

Taxation of certain equipment leasing

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

Other taxation by source country

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

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

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

Issue

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

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

C. Royalty Source Rules

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

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

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

D. Income from the Rental of Ships and Aircraft

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

E. Treaty Shopping

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

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

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

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

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