[COMMITTEE PRINT]

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

PREPARED FOR THE USE OF THE

COMMITTEE ON FOREIGN RELATIONS
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SEPTEMBER 21, 1981

U.S. GOVERNMENT PRINTING OFFICE
81-623 O WASHINGTON : 1981 JCS-44-81

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INTRODUCTION

This pamphlet describes the proposed income tax treaty between the United States and the State of Israel and the proposed protocol to that proposed treaty, which have been submitted to the Senate for advice and consent to ratification. The pamphlet covers the treaty as signed on May 30, 1980. It has been scheduled for a public hearing on September 24, 1981, by the Senate Committee on Foreign Relations.

There is presently no income tax treaty in force between the United States and Israel. The proposed treaty replaces a proposed income tax treaty between the United States and Israel signed on June 29, 1965, which was submitted to the Senate for advice and consent and subsequently withdrawn.

The first part of the pamphlet is a summary of the provisions of the proposed treaty that differ from the U.S. model income tax treaty. The second part provides an overview of U.S. tax rules relating to international trade and investment and U.S. tax treaties in general. This is followed by a detailed, article-by-article explanation of the proposed treaty.

I. SUMMARY

In General

The proposed treaty is intended to reduce or eliminate double taxation of income earned in one country by residents of the other country, to assist in collection and other administrative matters between the United States and Israel, and to promote closer economic cooperation and more active trade between the two countries.

The proposed treaty is substantially similar to other recent United States income tax treaties and to the model income tax treaty of the Organization for Economic Cooperation and Development (OECD). The proposed treaty does, however, contain several new provisions not found in other U.S. tax treaties. The more significant features of the proposed treaty are summarized below.

(1) The proposed treaty contains a new provision, not found in previous U.S. tax treaties, which details the U.S. tax treatment of certain Israeli governmental grants designed to stimulate U.S. investment in Israel (Article 10. Grants). The provision provides generally that Israeli governmental grants to U.S. shareholders of Israeli corporations which are made subject to the condition that the U.S. shareholders contribute the grants to the Israeli corporations, will be treated for U.S. tax purposes as nontaxable shareholder contributions to capital. The treaty confirms applicable U.S. tax treatment which requires a reduction in the basis of the assets of the Israeli corporation for purposes of determining the Israeli subsidiary's earnings and profits.

The Israeli Government has not as yet established a program under which such grants to U.S. shareholders will be made (although a grant program has been established under which investment incentive grants are made directly to the Israeli subsidiaries).

(2) The proposed treaty contains a provision not found in previous tax treaties (although also contained in the pending Moroccan treaty) under which certain Israeli compulsory war loans and security loans will be treated as income taxes so that the U.S. will allow a foreign tax credit for the loans (Articles 1 and 26). When the loans are repaid, they are to be treated as a refund of Israeli taxes with adjustments to U.S. tax liability at that time. In addition to providing for the treatment of the compulsory loans as creditable taxes, rules are provided with respect to the treatment of interest received on the loans and for the treatment of any gains realized on the repayment of the loans which are more favorable to the taxpayers than otherwise would apply. This loan requirement is no longer in effect.

(3) Although the proposed treaty (Article 15) provides the normal general rule that capital gains are taxable in the country of residence and exempt in the source country, there are two exceptions to this rule. First, Israel may tax the gain of a U.S. resident on the sale of shares of stock in an Israeli corporation if the resident owns more than 50 percent of the voting power of the Israeli corporation and a majority

of the business assets of the corporation are located in Israel. Second, the provision preserves the right of the United States to tax the gain of Israeli residents on the sale of certain U.S. entities owning interests in U.S. real property.

(4) The maximum rate of withholding tax by the source country on dividends received by residents of the other country is limited (Article 12) to 25 percent generally, and to 12.5 percent or 15 percent in the case of dividends received by shareholders having at least a 10 percent ownership interest (except where the distributing corporation is an investment company). These rates are somewhat higher than those ordinarily provided in U.S. tax treaties.

(5) The withholding tax in the source country on interest paid to residents of the other country is limited to 17.5 percent (Article 13). This higher than normal rate is reduced to 10 percent in the case of interest received by finance institutions. Interest received, guaranteed, or insured by a government or agency of either country will be exempt from tax by the other country.

(6) The maximum withholding tax rate on industrial royalties is limited to 15 percent and the maximum rate on corporate or firm royalties to 10 percent (Article 14).

(7) The provisions of the proposed treaty dealing with the taxation of business (Articles 5 and 8) and personal services income (Articles 16 through 24), are essentially the same as in our other recent treaties, as are the provisions dealing with definitional and administrative matters. For example, a resident of one country will not be subject to tax in the other country on business profits unless those profits are attributable to a permanent establishment which the resident maintains in the other country. Similarly, for business visitors from one country temporarily present in the other, the host country may tax the visitors only if certain tests (based on time spent or amounts earned) are met.

(8) The proposed treaty (Article 9) exempts from tax at source income derived by Israeli or U.S. residents from the operation (and gains on the sale) of ships and aircraft in international traffic.

(9) Finally, in a note of transmittal attached to the treaty, the United States agrees, when appropriate and feasible, to resume discussions with Israel with a view toward reaching agreement on provisions which would minimize the conflicts between the U.S. tax system and incentives offered to some investors by the Israeli Government. The note of transmittal is similar in effect to notes exchanged in connection with the U.S. income tax treaties with a number of developing countries, including Trinidad and Tobago, and the Republic of Korea.

Issues

(1) Forced loans.—The proposed treaty would require the United States to treat as income taxes certain loans which a U.S. business operating in Israel is required to make the Israeli government. Thus, the U.S. business would be allowed a foreign tax credit for the amount of the loan. However, a repayment of the loan will be treated as a refund of Israeli tax to the U.S. business, and thus the taxpayer's creditable foreign taxes would be reduced in the year of repayment. As a practical matter, this amounts to a loan from the U.S. government to Israel, with the taxpayer as the middleman. This treatment is accorded only to corporations which become subject to the loans requirements before April 1, 1977 but only if levied for taxable years ending before April 1, 1988. We understand that the Israeli government no longer requires loans. A similar, but more expensive provision is contained in the proposed treaty with Morocco.

(2) ***Dividends.***—The dividend rates are not reciprocal in certain tax holiday cases. Dividends on a direct investment in an Israeli corporation subject to a tax holiday are taxed at a 15-percent rate while dividends on a direct investment in either a U.S. corporation or an Israeli corporation not subject to a tax holiday would be taxed at a 12.5 percent rate. Dividends from portfolio investment are taxed at a 25-percent rate. As a general policy, the United States has insisted on reciprocity, although exceptions have been agreed to to reflect the treaty partner's law. This provision raises the issue of whether strict reciprocity should be insisted upon as a matter of policy.

(3) ***Interest.***—The treaty permits a 17.5-percent rate of tax at source on payments to persons other than banks, insurance companies or governmental units. The rate for payments to financial institutions, which generally have the greatest problems, is 10 percent. The 17.5-percent rate is the highest agreed to by the United States in any treaty and might establish a precedent for negotiations with other countries. However, in one proposed treaty there is no limitation on source basis taxation of interest. It is understood that Treasury would not have agreed to such a high rate without the lower rate for interest paid to financial institutions. This provision presents the issue of the appropriate level of source basis taxation of interest. Arguably, higher rates are appropriate in developing country treaties. On the other hand, it has been argued that rates that are too high are counterproductive to U.S. treaty policy and to the developing countries.

(4) ***Charitable contributions.***—On a reciprocal basis, the protocol to the treaty would permit a U.S. person to treat as a charitable contribution a contribution to an Israeli charitable organization. In the case of an individual, the amount treated as a contribution (which is subjected to the U.S. Code limits) cannot exceed 25 percent of adjusted gross income from Israeli sources (25 percent of taxable income for a corporation). A similar provision is contained in the existing Canadian treaty and the pending revision of that treaty. This provision raises an issue because the United States generally does not give a deduction by treaty.

(5) ***Exchange of information.***—An exchange of notes makes clear that due to resource and technical problems Israel cannot, at this time, provide routine information as to U.S. recipients of dividends, interests and royalties from Israel. They have agreed to provide the United States with this information as soon as possible. This type of information is normally received from treaty partners, and is supplied to them by the IRS. The failure to receive this information would make it more difficult for the IRS to detect such amounts that may not be reported. We are, of course, better off in this regard with a treaty than without one. Also, information on specific cases will be supplied by Israel.

(6) ***Developing county concessions.***—A number of the issues discussed above arise because of concessions to Israel reflecting its status as a developing country. The question of the appropriateness of these concessions might be addressed.

II. OVERVIEW OF UNITED STATES TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND TAX TREATIES

A. United States Tax Rules

The United States taxes U.S. citizens and residents and U.S. corporations on their worldwide income. The United States generally taxes nonresident alien individuals and foreign corporations only on their U.S. source income.

Income of a nonresident alien or foreign corporation which is effectively connected with the conduct of a trade or business in the United States is subject to tax at the normal graduated rates on the basis of net taxable income. Deductions are allowed in computing effectively connected taxable income, but only if and to the extent they are connected with income which is effectively connected.

U.S. source fixed or determinable, annual or periodical income (e.g. interest, dividends, rents, salaries, wages, premiums, annuities) which is not effectively connected with a U.S. trade or business is subject to tax at a rate of 30 percent of the gross amount paid to the nonresident alien or foreign corporation. This gross tax on fixed or determinable income is often reduced or eliminated in the case of payments to residents of countries with which the U.S. has an income tax treaty. The 30-percent (or lower treaty rate) tax imposed on U.S. source noneffectively connected income paid to foreign persons is collected by means of withholding (hence they are often called withholding taxes).

Certain exemptions from the gross tax are provided. Bank account interest is defined as foreign source interest and, therefore, is exempt. Exemptions are also provided for certain original issue discount and for income of a foreign government from investments in U.S. securities. Our treaties also provide for exemption from tax in certain cases.

Net U.S. source capital gains are also subject to the 30 percent tax but only in the case of a nonresident alien who is present in the United States for at least 183 days during the taxable year. Otherwise foreign corporations and nonresident aliens are only subject to U.S. taxation (at the graduated rates) on those capital gains that are effectively connected with the conduct of a trade or business in the United States.

Prior to June 18, 1980, noneffectively connected capital gains from the sale of U.S. real estate were subject to U.S. taxation only if received by a nonresident alien who was present in the United States for at least 183 days. However, in the Omnibus Reconciliation Act of 1980 a provision was added to the Internal Revenue Code that the sale, exchange or disposition of U.S. real estate by a foreign corporation or a nonresident alien would be taxed as effectively connected income. Also taxable under the legislation are dispositions by foreign investors of their interests in certain U.S. corporations and other entities whose assets include U.S. real property and associated personal property.

The source of income received by nonresident aliens and foreign corporations is determined under special rules contained in the Internal Revenue Code. Under these rules interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation are considered U.S. source income. However, if the U.S. corporation derives more than 80 percent of its gross income from foreign sources, then dividends and interest paid by such corporation will be foreign source rather than U.S. source. Conversely dividends and interest paid by a foreign corporation, which has at least 50 percent of its income as effectively connected income, are U.S. source to the extent of the ratio of its effectively connected income to total income.

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

Since it taxes U.S. persons on their worldwide income, double taxation of income can arise because income earned abroad by a U.S. person will be 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 by allowing U.S. taxpayers to credit their foreign income taxes against the U.S. tax imposed on their foreign source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that insures that the foreign tax credit only offset the U.S. tax on foreign source income. This limitation is computed on a world-wide consolidated basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income. Separate limitations on the foreign tax credit are provided for certain interest, DISC dividends,, and oil income.

A U.S. corporation that owns 10 percent or more of the stock of a foreign corporation may credit foreign income taxes paid or deemed paid by that foreign corporation on earnings that are received as dividends. These deemed paid taxes are included in total foreign taxes paid for the year the dividend is received and go into the general pool of taxes to be credited.

B. United States Tax Treaties—In General

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

Notwithstanding the unilateral relief measures of the United States and our treaty partners, double taxation might arise because of differences in source rules between the United States and the other country. Likewise, if both countries consider the same deduction allocable to foreign sources, double taxation can result. Significant problems arise in the determination of whether a foreign tax qualifies for the U.S.

foreign tax credit. Also, double taxation may arise in those limited situations where a corporation or individual may be treated as a resident of both countries and be taxed on a worldwide basis by both.

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

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

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

Treaties first seek to eliminate double taxation by defining the term "resident" so that an individual or corporation generally will not be subject to tax as a resident by each of the two countries. The treaty also provides that neither country will tax business income derived from sources within it by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a branch or other permanent establishment or fixed base. The treaties contain commercial visitation exemptions under which individual residents of one country performing personal services in the other will not be required to file tax returns and pay tax in that other country unless their contracts exceed certain specified minimums. For example, presence for a set number of days or earnings of over a certain fixed dollar amount.

The treaties deal with passive income such as dividends, interest, or royalties, or capital gains, from sources within one country derived by residents of the other country by either providing that they are taxed only in the country of residence or by providing that the withholding tax generally imposed on those payments is reduced. As described above, the U.S. generally imposes a 30 percent tax and seeks to reduce this tax in some cases on some income to zero in its tax treaties.

In its treaties, the United States, as a matter of policy, retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect, and provides this in the treaties in the so-called "saving clause." Double taxation can therefore still arise. Double taxation can also still arise because most countries will not exempt passive income from tax at source.

This double taxation is further mitigated either by granting a credit for income taxes paid to the other country, or, in the case of some of our treaty partners, by providing that income will be exempt from tax in the country of residence. The United States provides in its treaties that it will allow a credit against United States tax for income taxes paid to the treaty partners, subject to the limitations of U.S. law. An important function of the treaty is to define the taxes to which it applies to provide that they will be considered creditable income taxes for purposes of the treaty.

The treaties also provide for administrative cooperation between the countries. This cooperation includes a competent authority mechanism to resolve double taxation problems arising in individual cases. or more generally, by consultation between tax officials of the two governments.

Administrative cooperation also includes provision for an exchange of tax-related information to help the United States and its treaty partners administer their tax laws. The treaties generally provide for the exchange of information between the tax authorities of the two countries where such information is necessary for carrying out the provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information not obtainable under its laws or in the normal course of its administration, or to supply information which would disclose trade secrets or other information the disclosure of which would be contrary to public policy.

The provisions generally result in an exchange of routine information, such as the names of U.S. residents receiving investment income. The 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.

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III. EXPLANATION OF PROPOSED TAX TREATY

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

Article 1. Taxes Covered

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

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

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

Article 2. General Definitions

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

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

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

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

Article 3. Fiscal Residence

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

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

Corporations which qualify as residents of both the United States and Israel will not be entitled to the benefits of the proposed treaty other than those dealing with nondiscrimination (Article 27) and exchange of information (Article 29). Dual residence of a corporation may arise under the proposed treaty where a corporation incorporated in the United States is taxed by Israel as a body of persons resident in Israel. If the treaty were to apply to such corporations, the United States would be obligated to extend to them as residents of Israel the benefits provided by the proposed treaty. Since it is contrary to U.S. tax policy to restrict United States taxation of U.S. corporations, dual resident corporations are removed from the scope of the substantive tax provisions of the proposed treaty. Under the protocol, the source roles (Article 4) and the entry into force (Article 31) also apply to dual resident corporations.

Article 4. Source of Income

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

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

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

In addition, the source rule for interest paid by permanent establishments will operate to exempt interest from tax in the country of the payor's residence if the interest is paid to a resident of the other country by a permanent establishment situated in a third country (and the indebtedness was incurred in connection with the third country permanent establishment). This results from the restriction in Article 6 (General Rules of Taxation) that a resident of one country who is not a citizen of the other country may be taxed by the other country only on income from sources within that other country.

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

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

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

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

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

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

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

Article 5. Permanent Establishment

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

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

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

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

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

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

A resident of one country will be deemed to have a permanent establishment in the other country if it has an agent in the other country who has, and habitually exercises, a general authority (other than for the purchase of mechandise) to conclude contracts in that other country in the name of the resident. The proposed treaty contains the usual provision that the agency rule will not apply if the agent is a broker, general commission agent or other agent of independent status acting in the ordinary course of its business.

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

Article 6. General Rules of Taxation

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

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

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

Article 7. Income from Real Property

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

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

Article 8. Business Profits

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

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

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

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

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

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

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

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

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

Guidelines are provided for determining what income is effectively connected with a permanent establishment. Factors to be taken into account include whether the rights or property giving rise to the income are used in (or held for use in) carrying on an activity giving rise to industrial or commercial profits through a permanent establishment and whether the activities carried on through the permanent establishment are a material factor in the realization of the income. For this purpose, due regard will be given to whether or not the property or rights or the income are accounted for through the permanent establishment. The effectively connected concept in this paragraph is substantially similar to the effectively connected concept in the Code (sec. 864(c)).

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

Article 9. Shipping and Air Transport

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

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

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

Article 10. Grants

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

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

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

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

Article 11. Related Persons

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

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

Article 12. Dividends

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

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

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

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

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

Article 13. Interest

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

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

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

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

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

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

Article 14. Royalties

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

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

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

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

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

Article 15. Capital Gains

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

The proposed treaty generally provides that capital gains derived by a resident of one country will be exempt from tax by the source country. The exemption does not apply where an individual resident of one country is present in the source country for 183 days or more during the taxable year. In addition, this provision does not apply to gains which are subject to the provisions relating to business profits

(Article 8), income from real property (Article 7), royalties (Article 14), or shipping and air transport (Article 9).

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

The proposed treaty contains an additional exception to the capital gains exemption which is not in previous U.S. tax treaties. Under Israeli tax law, gains from the sale of stock in an Israeli corporation are subject to tax by Israel regardless of where the sale occurs. Under this exception, Israel may tax a U.S. resident on the gain derived from the sale, exchange, or other disposition of stock in an Israeli corporation if (1) the U.S. resident actually or constructively owns, within the 12-month period preceding the transaction, stock representing more than 50 percent of the voting power of the Israeli corporation, and (2) more than 50 percent of the fair market value of the Israeli corporation's gross assets used in its trade or business are physically located in Israel on the last day of each of the 3 preceding taxable years.

Article 15A. Charitable Contributions

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

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

Article 16. Independent Personal Services

Under the Code, the income of a nonresident alien from the performance of personal services in the United States is not taxed if the individual is not in the United States for at least 90 days, the compensation does not exceed $3,000, and the services are performed as an employee of a foreign person not engaged in a trade or business in the United States or they are performed for a foreign permanent establishment of a U.S. person. His income is taxed at regular rates if the income is effectively connected with the conduct of a trade or business in the United States by the individual. (See discussion of U.S. taxation of business profits under Article 8. The performance of personal services within the United States can be a trade or business within the United States (sec. 864(b)).

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

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

Article 17. Dependent Personal Services

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

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

Article 18. Public Entertainers

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

Article 19. Amounts Received for Furnishing Personal Services of Others

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

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

Article 20. Private Pensions and Annuities

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

Article 21. Social Security Payments

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

Article 22. Governmental Functions

Under the proposed treaty, wages, including pensions or similar benefits, paid by one country to an individual for labor or personal services performed for that country in the discharge of governmental functions is exempt from tax by the other country. This exemption does not apply if the individual performing the services is a citizen of, or acquires immigrant status in, the country where the services are performed. The exemption only applies to compensation for services performed for the national governments of the United States and Israel or their agencies.

Article 23. Teachers

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

Article 24. Students and Trainees

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

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

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

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

Article 25. Investment or Holding Companies

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

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

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

Article 26. Relief From Double Taxation

Background

One of the two principal purposes for entering into an income tax treaty is to limit double taxation of income earned by a resident of one of the countries that may be taxed by the other country. The United States seeks to mitigate double taxation unilaterally by allowing U.S. taxpayers to credit the foreign income taxes that they pay against the U.S. tax imposed on their foreign source income.

A fundamental premise of the foreign tax credit is that it may not offset U.S. tax on U.S. source income. Therefore, the foreign tax credit provisions contain a limitation that insures that the foreign tax credit only offset U.S. tax on foreign source income. This limitation is computed on a worldwide consolidated basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income. Separate limitations on the foreign tax credit are provided for certain interest, DISC dividends, and oil income. A U.S. corporation that owns 10 percent or more of the stock of a foreign corporation may credit foreign taxes paid or deemed paid by that foreign corporation on earnings that are received as dividends (deemed paid credit). These deemed paid taxes are included in the U.S. shareholder's total foreign taxes paid for the year the dividend is receive and go into the general pool of taxes to be credited.

Unilateral efforts to limit double taxation are imperfect. Because of differences in rules as to when a person may be taxed on business income, a business may be taxed by two countries as if it were engaged in business to both countries. Also, a corporation or individual may be treated as a resident of more than one country and be taxed on a worldwide basis by both.

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

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

Proposed treaty

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

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

For the purpose of applying the U.S. foreign tax credit under the treaty in relation to taxes paid to Israel, the rules set forth under Article 4 will be applied to determine the source of income. The Israeli taxes which the proposed treaty provides are creditable for U.S. tax purposes are the Israeli income tax (including capital gains tax), the company tax, the tax on gains from the sale of land under the land appreciation tax law, the tax on income levied under the services tax law (banking institutions and insurance companies), and certain compulsory war loans and security loans. With the exception of the compulsory loans, these taxes would probably be creditable for U.S. tax purposes in the absence of the proposed treaty. The compulsory loans are not creditable income taxes for U.S. foreign tax credit purposes.

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

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

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

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

Article 27. Nondiscrimination

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

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

Article 28. Mutual Agreement Procedure

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

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

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

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

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

Article 29. Exchange of Information

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

Information exchanged is to be treated as secret except that it may be disclosed to any person concerned with or made a part of a public record with respect to the assessment or collection, or litigation concerning, the taxes to which the treaty applies. It is not clear from the language of the proposed treaty that Congress, in the exercise of its oversight responsibilities could have access to the information. However, a country is not required to carry out administrative measures contrary to its law or administrative practice, to supply particulars not obtainable under its laws or in the normal course of administration or to supply information that would disclose a trade secret or the disclosure of which would be contrary to public policy.

Article 30. Diplomatic and Consular Officials

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

Article 31. Entry into Force

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

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

Article 32. Termination

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

Exchange of Notes

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

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

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

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

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