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MEMORANDA

[MAY 26, 1964]

Review of the Pending Tax Conventions and Protocols With Greece, Japan, Luxembourg, the Netherlands Antilles, and Sweden

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ESTATE TAX CONVENTION WITH GREECE

The protocol dated February 12, 1964, would modify and supplement the estate tax convention dated February 20, 1950, between the United States of America and Greece.

Prior to October 17, 1962, real property situated outside the United States was not includible in the gross estate, for Federal estate tax purposes, of a decedent who was a citizen or resident of the United States at the time of his death. However, depending upon when the real property situated outside the United States was acquired, this basic rule was changed (sec. 18 of the Revenue Act of 1962, Public Law 87-843, 87th Cong.) so that real property wherever situated is includible in the gross estate of a U.S. decedent. More specifically, if a decedent dies in the period between October 16, 1962, and July 1, 1964, only real property situated outside the United States which the decedent acquired after January 31, 1962, is includible in his gross estate. However, if the decedent dies after June 30, 1964, real property situated outside the United States will be includible in his gross estate without regard to when the decedent acquired the property.

Since article III(1) of the estate tax convention with Greece provides that "immovable property situated in Greece shall be exempt from the application of the [estate] taxes imposed by the United States" an inconsistency exists between the statutory provisions of the Internal Revenue Code and the obligation of the United States under the estate tax convention with Greece. However, this inconsistency was resolved by the Congress when it passed the Revenue Act of 1962 by providing (sec. 31 of the Revenue Act of 1962) that the new statutory law adopted in the act would take precedence over prior treaty obligations.

The pending protocol would amend the present convention by deleting article III(1) so as to bring the obligation of the United States under the convention into line with the governing statutory rule. Thus, the application of the statutory rule would cease to be in contravention of the existing treaty obligation as soon as there is an exchange of instruments of ratification between the United States and Greece with respect to the protocol.

The protocol would also (1) permit Greece to include real property situated in the United States in the gross estate of decedents who are citizens or residents of Greece at the time of their death (although under present Greek estate tax law such property will continue to be excluded from the gross estate of Greek decedents); and (2) change the title of the convention so as to refer only to the avoidance of double taxation on the "movable" property of deceased persons.

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INCOME TAX CONVENTION WITH JAPAN

The protocols between the United States and Japan signed on May 7, 1960, and August 14, 1962, have the general purpose of making the income tax convention with Japan conform more closely with other income tax conventions to which the United States is a party. They also remove inequities and resolve technical problems which have arisen under the present convention. The 1954 convention, as supplemented by a protocol signed at Tokyo on March 23, 1957, is presently in force. The 1957 protocol would terminate when the 1960 protocol becomes effective.

BUSINESS PROFITS

Under the present convention, the industrial or commercial profits of an enterprise of one country are taxable in the other country only if the enterprise has a permanent establishment in the other country. The term "permanent establishment," as presently defined, means, among other things, "an office, factory, workshop, branch, warehouse, or other fixed place of business." Under this definition, controversy has arisen between the United States and Japanese authorities with respect to the taxation of enterprises of one country which engage in the construction business in the other country. The United States has taken the position that construction-related activities do not, by themselves, constitute the creation of a "permanent establishment," while the Japanese have taken a contrary position. The 1962 protocol resolves the issue by holding that an enterprise of one country is deemed to have a permanent establishment in the other country if it has a "construction, installation, or assembly project" which lasts for more than 12 months in the other country, or if an enterprise carries on supervisory activities in the other country in connection with such a project for a period of more than 12 months. Conversely, construction activities will not, by themselves, constitute the maintenance of a permanent establishment if the resulting activity in the other country lasts 12 months or less. This method of treatment is consistent with that adopted in the tax conventions the United States has with Austria and West Germany; moreover, it adopts the approach incorporated in the draft convention approved by the Fiscal Committee of the Organization for Economic Cooperation and Development (OECD). The proposed U.S. tax convention with Luxembourg also provides similar treatment for construction projects, but adopts a 6-month period, rather than a 12-month period, as a basis for distinction.

Although construction activities in a host country may result, under the proposed definition, in the taxation of industrial or commercial profits in that country, it will not result in the denial of reduced tax in the host country on dividend, interest, and royalty income from sources within the host country if such income is not attributable to the construction activity and the recipient does not otherwise have a permanent establishment in the source country.

DIVIDENDS

Under the present convention, which does not modify U.S. statutory law in this respect, Japanese residents (other than U.S. citizens) are currently subject to U.S. tax tax on dividend income from sources within the United States at a 30-percent rate (which is withheld at source) if their U.S. source income does not exceed $19,000 a year ($21,200 for taxable years beginning in 1965) and are subject to tax on U.S. source income at the graduated rates applicable to individuals generally if their U.S. source income exceeds $19,000 a year ($21,200 for taxable years beginning in 1965). Similarly, Japanese corporations which are not engaged in trade or business within the United States are taxable at a flat 30-percent rate on their U.S. source dividend income. Conversely, U.S. citizens (other than those resident in Japan), U.S. residents, and U.S. corporations and other entities which do not maintain a permanent establishment in Japan are exempt from Japanese tax on dividends received from Japanese corporations. Moreover, U.S. shareholders of Japanese corporations are allowed a credit against their U.S. tax, on a gross-up basis, as if the Japanese withheld tax at a 25 percent rate. Thus, for example, if a U.S. resident receives a $100 dividend from a Japanese corporation, the U.S. taxpayer is required to include $125 in gross income, but is allowed a $25 credit against his tentative U.S. tax, subject, of course, to the overall and per-country limitations of section 904 of the Internal Revenue Code. In addition, if the recipient is a U.S. corporation, it is entitled to a credit for a pro rata share of the Japanese income, war profits, and excess profits tax paid by a 10-percent-owned payor corporation (or 50-percent-owned second tier subsidiary) under the provisions of section 902 of the Internal Revenue Code.

The 1962 protocol would terminate the provisions of the present convention relating to the foreign tax credit provisions and would adopt the approach for relief of double taxation on dividend income contained in most income tax conventions to which the United States is a party. This would be accomplished by limiting the tax of the source country on dividends paid to residents, corporations, and other entities of the other country to a maximum rate of 15 percent, regardless of the amount of the recipient's income, if the recipient does not have a permanent establishment in the source country. This approach would have the effect of reducing U.S. tax payable by Japanese residents on dividend income from U.S. sources from 30 percent (or higher rates if the U.S. source income of an individual recipient exceeded $19,000 in taxable year 1964) to 15 percent. Conversely, it would generally increase the Japanese tax payable by U.S. shareholders of Japanese corporations from 0 to 15 percent and would increase the overall U.S. tax payable by U.S. shareholders of Japanese corporations by denying them a tax credit against their tentative U.S. tax for the 25 percent Japanese tax they are presently deemed to have paid.

Besides conforming this convention to the type of reciprocal formula embodied in most other conventions, this provision should help the U.S. balance-of-payments position by encouraging Japanese investments in the United States and by making U.S. investments in Japan less attractive. Moreover, in light of the present development of the Japanese economy, it is questionable if it is necessary for the United States to continue tax incentives for its citizens to invest in Japan.

The 1962 protocol also provides for a further reduction of tax in the country of the payor to a rate not to exceed 10 percent if the dividend is paid to a corporate shareholder of the other country who, together with no more than three other 10-percent or more corporate shareholders, owns at least 50 percent of the total voting power of all classes of stock, entitled to vote, or 50 percent of the total value of all classes of stock, of the distributing corporation. This provision would not apply, however, if more than 25 percent of the gross income of the distributing corporation consists of interest and dividends from less than 50-percent-owned subsidiary corporations. This additional reduction of tax by the source country on intercorporate dividends is consistent with the policy adopted by the United States in its convention with Norway and in the proposed conventions with Luxembourg and Sweden. The 1962 protocol differs from these conventions by extending the reduced rate to cases where 50 percent of the value of the stock of the distributing corporation is held by not more than four 10-percent or more corporate shareholders (one of whom is the recipient) in addition to cases where such persons own 50 percent of the voting stock of the distributing corporation. However, by extending the scope of the provision, the protocol more closely approximates the Internal Revenue Code treatment of intercorporate dividends which allows an 85 percent dividends received deduction to corporate shareholders without regard to the degree of their stockownership in the distributing corporation.

INTEREST

The present convention provides, in general, that interest paid from sources within one country to a resident, corporation, or other entity of the other country not maintaining a permanent establishment in the first country is to be taxed in the source country at a rate not to exceed 15 percent. The 1962 protocol reduces the maximum source country rate to 10 percent. However, in the case of Japanese source interest, the present 5-percent Japanese statutory withholding rate will continue to apply until March 31, 1965, at which time the rate would increase to the proposed 10-percent treaty rate. These rates compare with the 30-percent United States and 20-percent Japanese (after March 31, 1965) withholding rates that would be applicable in the absence of the convention.

The 1960 protocol provides that interest received by the Bank of Japan, and the Export-Import Bank of Japan, from sources within the United States, and interest received by the Federal Reserve banks of the United States, and the Export-Import Bank of Washington, from sources within Japan, are to be completely exempt from tax in the source country. This provision expands the exemption provided by the 1957 protocol (which would be superseded) so as to include the Bank of Japan and the Federal Reserve banks of the United States. In general, the additional exemptions provided by the 1960 protocol correspond to the provisions of section 895 of the Internal Revenue Code which exempt foreign central banks of issue from U.S. tax on U.S. source interest income. Moreover, complete exemption of interest income from tax in a source country is granted in many tax conventions to which the United States is a party.

INCOME FROM REAL PROPERTY AND MINERAL ROYALTIES

Under the present convention, a resident, or corporation or other entity of one of the contracting countries who receives mineral royalties, or income from real property, from sources within the other country may elect to be taxed in the source country on a net income basis. The 1960 protocol makes it clear that the election to be taxed on a net basis applies only to income from real property and royalties in respect of the operation of mines, quarries, or other natural resources.

NONMINERAL ROYALTIES

Under the present convention, royalty income received from sources within one of the contracting countries by a resident, corporation, or other entity of the other country not maintaining a permanent establishment in the first country is taxable in the source country at a rate not to exceed 15 percent. The 1962 protocol provides that the source country rate of tax shall be at a rate not to exceed 10 percent. Since U.S. individuals and corporations receive substantially more royalty income from Japanese sources than Japanese persons receive from the United States, the proposed reduction in source country tax should benefit the United States to the greater extent. The protocol also redefines the term "royalties" to bring it more in line with the more specific definitions contained in the more recent conventions to which the United States is a party. The substance of the definition is, however, not changed.

COMPENSATION FOR PERSONAL SERVICES

The 1960 and 1962 protocols make two basic changes in the tax treatment of income from personal services.

First, under the present convention, wages, salaries, or similar compensation paid by a government of one of the contracting countries to one of its citizens for services rendered as an employee of the government in the discharge of a governmental function, are, in general, exempt from tax by the other country. The 1960 protocol expands the application of this provision to provide (1) that government pension and annuity payments received by citizens of the payor country will be exempt from tax in the other country if the pension or annuity is paid with respect to services rendered as an employee of the payor government in discharge of its governmental functions and (2) that pensions or annuities paid to residents of one country by the government of the other country are to be taxed only in the country of the recipient's residence to the extent the pension or annuity is allocable to services the remuneration for which was exempt from tax by the payor country. Thus, for example, U.S. citizens resident in Japan (other than those admitted to Japan on a permanent residence basis) will be exempt from Japanese tax on their U.S. Government annuities and Japanese nationals resident in Japan will be exempt from U.S. tax on pensions received from the United States on account of services rendered outside the United States as employees of the U.S. Government.

Second, under the present convention, a resident of one of the contracting countries is exempt from tax in the other contracting country on compensation received for labor or personal services performed in the other country if (1) the resident is present in the other country for not more than 180 days during a taxable year and (2) the compensation is received for services performed as an officer or employee of a corporation of the country in which the recipient of the income is resident. Exemption is also provided if a resident of one country is present in the other country for a period not exceeding 90 days in a taxable year if the compensation received does not exceed $3,000. The 1962 protocol does not change the 90-day $3,000 rule; however, it makes the 180-day rule inapplicable if (1) the officer or employee who performs the services for which the compensation is received owns 25 percent or more of the voting stock of the corporation, or 25 percent of the value of all classes of stock of the corporation, and (2) 50 percent or more of the income of the corporation from sources within the other country is derived from furnishing the labor or personal services of one or more such 25-percent shareholders. In applying the 25-percent stockownership test, a person is considered to own stock held, directly or indirectly, by his brothers, sisters, spouse, ancestors, and descendants. The 50-percent test is based on net income from sources within the other country, plus gross compensation paid 25-percent shareholders for furnishing labor or personal services.

The protocol also provides, in effect, that if a corporation receives income for furnishing the labor or personal services of a 25-percent shareholder, and 50 percent or more of the corporation's net income (plus gross compensation paid 25-percent shareholders) consists of such income, the corporation will be taxable on such income in the country where the services are performed, whether or not it maintains a permanent establishment in that country. There would, of course, be no tax at the corporate level if such amounts are paid out as compensation to 25-percent shareholders or if the amounts received would have been exempt under the 90-day, $3,000 rule if distributed to the shareholder who performs the service.

The special rule limiting application of the 180-day exemption provision for corporate officers and employees may apply to persons of any profession who perform personal services for a corporation in which they own 25 percent of the stock. However, the provision will have its greatest impact in the case of persons engaged in the entertainment business. In general, the change will not affect the overall tax liability of U.S. persons affected, but merely shifts the tax from the country of residence to the country in which the services are performed. Thus, for example, if a U.S. citizen performs personal services in Japan as an employee of a domestic corporation in which he owns 100 percent of the stock, the compensation he receives from his corporation (providing it exceeds $3,000) will be taxable in Japan, regardless of how long he is present in Japan during the year. However, the Japanese tax would be allowable as a credit against the shareholder's tentative U.S. tax. Similar results would also follow if the compensation remained at the corporate level in that the U.S. corporation would be taxable on the personal services income as income from sources within Japan, even if the corporation does not have a permanent establishment in Japan (since personal service income would be excluded from the term "industrial or commercial profits") and the Japanese tax would be allowed as a credit against U.S. tax otherwise payable by the corporation.

Although there is some question whether the constructive ownership rules adopted are appropriate in that they provide attribution between possibly estranged persons (for example, brothers or sisters), there is little practical likelihood that the shareholders will in practice be estranged since at least 50 percent of the adjusted net income of the corporation must be derived from labor or personal services of one or more major shareholders.

SOURCE OF INCOME RULES

The present convention establishes rules for determining the source of income for convention purposes. These rules generally parallel the U.S. statutory rules contained in sections 861 through 863 of the Internal Revenue Code. The 1960 and 1962 protocols modify the rules relating to interest and personal service income.

In the case of interest, the present convention provides that interest paid by an enterprise of one of the contracting countries is to be treated as income from sources within the country of which the payor is an enterprise, unless the payor has a permanent establishment in the other country. If the payor has a permanent establishment in the other country, the convention source rule is no longer applicable and the source of interest income is determined under the appropriate laws of the United States and Japan. Since the laws of the countries may differ, so that both may treat the same income as income from sources within their respective countries, the present convention does not satisfactorily eliminate double taxation of income in this instance. For example, if a U.S. corporation receives interest from a Japanese corporation which maintains a permanent establishment in the United States, the interest paid by the Japanese debtor may be treated by the Japanese as income from sources within Japan (on the basis that the payor is a Japanese corporation) and may be treated by the United States as income from sources within the United States (if, for example, the payor is engaged in trade or business within the United States and derived 20 percent or more of its gross income from sources within the United States over the 3-year period ending with the close of the taxable year of the payor preceding the payment of the interest (sec. 861(a)(1)(B) of the Internal Revenue Code of 1954)). Under these circumstances, although the payor may withhold Japanese tax on the payment of the interest on the basis that the interest is Japanese source income, the United States may deny the recipient of the income a credit for the Japanese tax against his U.S. tax (under the provisions of sec. 904 of the Internal Revenue Code) on the grounds that the recipient has no income from sources within Japan.

The 1960 protocol modifies the basic rule to provide that interest paid by an enterprise of one of the contracting States is to be treated as income from sources within the payor's country, whether or not the payor maintains a permanent establishment in the other country. However, this basic rule is subject to two exceptions, if the indebtedness is incurred other than in connection with the purchase of ships or aircraft. First, if the payor maintains a permanent establishment in the other country and interest is paid on indebtedness incurred for the use of the permanent establishment in the other country, or on banking deposits made with the permanent establishment in the other country, the interest is deemed to be from sources within the country where the permanent establishment is located. Second, if the interest is paid on indebtedness incurred for the use of a permanent establishment of one of the enterprises located in a third country, or on banking deposits made with a permanent establishment of an enterprise of one of the contracting countries located in a third country, the income is to be treated as income from sources within the third country. These exceptions have the effect of treating such permanent establishments as separate corporations for source of income purposes and require the treaty country in which the payor is incorporated to exclude interest paid by a permanent establishment outside of that country from tax. Although this rule has not previously been adopted in income tax conventions to which the United States is a party, the result is consistent with the basic approach adopted in other conventions which exempt all interest from tax in the source country if the recipient does not have a permanent establishment in that country.

The 1962 protocol amends the source rule relating to the source of income of compensation for labor or personal services by providing that income derived by a corporation or other entity for furnishing labor or personal services is to be treated as income from sources within the country where the labor or services are rendered. This change correlates with the proposed change in the taxation of personal service income so as to permit the source country to tax a nonresident foreign corporation on the service income attributable to a 25-percent shareholder if the income remains at the corporate level. The 1962 protocol also conforms the source rule relating to income from royalties to the new definition contained in article VII(2) of the protocol.

FOREIGN TAX CREDITS

As previously noted, under the present convention U.S. citizens, residents, and corporations and other entities are allowed a tax credit against U.S. tax in an amount equal to 25 percent of their dividend income received from Japanese corporations, on a gross-up basis, even though no Japanese tax is in fact paid on the distribution of a dividend by a Japanese corporation. The 1962 protocol would eliminate this provision. Moreover, as a result of the changes made by the 1960 and 1962 protocols, the foreign tax credit provision of the convention would be amended so as to be consistent with corresponding provisions in other income tax conventions to which the United States is a party. Thus, the United States and Japan could tax their residents, corporations, and other entities (and citizens in the case of the United States) as if the convention had not come into effect if they allow such persons a foreign tax credit for the amount of tax paid to the other country (or any political subdivision or local government of the other country). In general, the statutory foreign tax credit provisions of the United States and Japan are similar, although Japan limits allowance of indirect credits to taxes paid by first tier corporations, rather than first and second tier foreign corporations as allowed by the United States, and Japanese law does not provide for a carryover or carryback of excess credits. The 1960 protocol also provides that the U.S. foreign tax credit would be determined in accordance with U.S. law applicable to the taxable year in question, rather than in accordance with the Internal Revenue Code in effect on January 1, 1954, as is required under the present convention.

EFFECTIVE DATE

In general, the modifications made by the 1960 and 1962 protocols would become effective with respect to payments made on or after January 1 of the year immediately following the year in which the exchange of instruments of ratification takes place. However, the change in the definition of a "permanent establishment," so as to include construction projects of more than 12 months' duration, would be applicable only with respect to projects begun after such January 1. Moreover, the present rules would continue to apply to dividend payments made during the first 2-year period beginning on January 1 of the year immediately following the year in which the exchange of instruments of ratification takes place if a dividend is paid by a Japanese corporation to a U.S. shareholder (other than a U.S. corporate shareholder owning 10 percent or more of the stock of the payor corporation) with respect to stock held by the shareholder prior to such January 1. However, in the third year, Japan would withhold tax at a 7.5-percent rate, rather than at a zero rate, and the United States would allow a credit, on a gross-up basis, of 12½ percent of the dividend, rather than 25 percent of the dividend. Thus, the new rules which provide for Japanese tax at a 15-percent rate, and for the elimination of the present 25-percent foreign tax credit for U.S. tax purposes, would apply only with respect to payments made after the 3-year transitional period.

TAX CONVENTION WITH LUXEMBOURG

The tax convention with Luxembourg has the general purpose of affording relief from double taxation resulting from the fact that the laws of the two countries impose tax on different bases. It also establishes procedures for mutual administrative assistance between the fiscal authorities of the two countries.

In the case of the United States, the convention applies only to the Federal income tax. In the case of Luxembourg, the convention applies to the Luxembourg tax on fees of directors of corporations, the wealth tax, and the communal taxes on commercial profits, invested capital, and land, as well as the Luxembourg income tax.

In general, Luxembourg levies an income tax on the worldwide income of its residents at rates ranging from approximately 0.18 percent on the first $550 of taxable income to 54 percent on income in excess of $40,000. Nonresidents are taxable only on income from sources within Luxembourg, and, except in the case of business income, the Luxembourg tax withheld at source generally satisfies the tax liability. In the case of corporate taxpayers, Luxembourg taxes the worldwide income of corporations having their central management or seat in Luxembourg, while other corporations are taxed only on income from sources within, or attributable to a fixed place of business within, Luxembourg. The corporate income tax is levied at a 20-percent rate on income of $8,000 or less, 30 percent on income between $8,000 and $20,000, and 40 percent on income above $20,000. However, in the case of corporations which are not managed, or do not have their seat, in Luxembourg, and do not have a fixed place of business within Luxembourg, tax is generally limited to the amount withheld at source. The Luxembourg statutory withholding rates which apply in the absence of the convention vary depending upon the nature of the payment; for example, the withholding rates are 15 percent on dividends, 5 percent on interest, 12 percent on industrial royalties, and 10 percent on most other royalties.

BUSINESS PROFITS

Corresponding to the principle of other income tax conventions, article III of this convention provides that an enterprise of one of the contracting countries will not be subject to tax on industrial or commercial profits by the other country unless it carries on business in the other country through a permanent establishment located within that country. However, this provision of the convention, and the related definitions contained in article II, are important in that it is the first time the United States has fundamentally adopted the definition of a "permanent establishment" contained in the draft convention for the avoidance of double taxation approved by the Fiscal Committee of the Organization for Economic Cooperation and Development (OECD), and a substantial part of the language of the OECD draft convention dealing with the rules by which profits attributable to a permanent establishment are to be determined.

In general, the recitation of factors that *do* constitute a permanent establishment generally conform to those contained in other U.S. tax conventions. Thus, if the business of an enterprise is wholly or partly carried on in the host country through a place of management, a branch, an office, a factory, a workshop, a mine, a quarry or other place of extraction of natural resources, or a building site, or construction or assembly project which exists for more than 6 months, an enterprise of the other country is deemed to have a "permanent establishment" in the host country. Moreover, the presence in a country of a person (other than an independent agent) who has, and habitually exercises, an authority to conclude contracts in the name of his principal, is deemed to constitute a permanent establishment. Thus, except for treating "a place of management" as a permanent establishment, and treating construction projects after 6 months as a permanent establishment, the affirmative portion of the definition is consistent with those contained in prior U.S. income tax conventions (for example, the conventions with Austria, West Germany, Italy, Japan, and Norway). Moreover, the definition is consistent with prior definitions in holding that the maintenance of a fixed place of business solely for the purpose of purchasing goods (and the employment of an agent for that purpose) does not constitute a permanent establishment.

However, the definition departs from prior conventions by itemizing several activities which *do not* constitute a permanent establishment. In general, the exceptions have the effect of permitting an enterprise of one of the contracting countries to economically penetrate the other country to a much greater degree than has heretofore been permitted without incurring an income tax in the host country. For example, under the definition, a Luxembourg enterprise may use U.S. facilities to display goods in the United States, maintain a separate fixed place of business in the United States for the purpose of advertising the goods, and, in addition, maintain an inventory of goods from which it may make delivery, without being considered to have a permanent establishment in the United States. Conversely, a U.S. enterprise could conduct similar activities in Luxembourg without being considered to have a permanent establishment in Luxembourg.

The convention also provides that the maintenance of a fixed place of business in a country "solely for the purpose of advertising, for the supply of information, for scientific research, or for similar activities which have a preparatory or auxiliary character, for the enterprise" will not be deemed to constitute a permanent establishment. Although the term "similar activities" is not defined, it is presumably intended to include, among other things, activities related to servicing a contract for technical services or a "know-how" contract. In general, exclusion of these type activities is based on the premise advanced by some that research, advertising, and related activities, do not, by themselves, produce profits and, therefore, should not, taken alone, be treated as a permanent establishment. Furthermore, some argue that even if profit were attributable to such activities, the amount involved would be negligible and would largely be offset by the administrative expense and inconvenience of collecting a tax.

The convention also provides that an enterprise will not be considered to have a permanent establishment in a country merely because it carries on business in that country through a broker, general commission agent, or any other agent of an independent status where such persons are acting in the ordinary course of their business. Similarly, an enterprise of one of the contracting countries will not be deemed to have a permanent establishment in the other country merely because it controls, or is controlled by, a corporate enterprise of the other state or a corporation which carries on business in the other state. These provisions are consistent with provisions contained in prior U.S. tax conventions.

Article III of the convention also provides that an enterprise of one country having a "permanent establishment" in the other country is to be subject to income tax by that country only on the industrial and commercial profits attributable to the "permanent establishment" in that country. In determining the profits attributable to a permanent establishment, different rules apply depending upon whether the permanent establishment is in Luxembourg or the United States.

If a Luxembourg enterprise has a permanent establishment in the United States, all industrial and commercial profits from sources within the United States would be deemed attributed to the permanent establishment, whether or not actually attributable to activities conducted by the permanent establishment. Conversely, non-U.S. source income would not be attributed to the permanent establishment even though attributable to activities conducted in the permanent establishment. If a U.S. enterprise has a permanent establishment in Luxembourg, industrial and commercial profits attributable only to the activities of the permanent establishment would be taxable by Luxembourg, without regard to the source of the income.

By adopting these conflicting rules, the convention follows the pattern of prior conventions by limiting the U.S. tax on the income of a permanent establishment in the United States to U.S. source income, while it follows the OECD draft convention with respect to allocation of income to a permanent establishment in Luxembourg.

In determining industrial or commercial profits, expenses incurred for the purposes of the permanent establishment would be allowable as deductions. However, expenses incurred in connection with the mere purchase of goods or merchandise, and expenses incurred by a permanent establishment in the United States in connection with non-U.S. source income, would not be allowable in calculating taxable profits of the permanent establishment. Moreover, all allocations of income and deductions would be subject to an overriding rule that they be allocated in a manner that would be expected if a permanent establishment were dealing with the enterprise of which it is a permanent establishment on an arm's-length basis.

The convention, for the first time, incorporates a rule which has been administratively followed by the United States to the effect that if an enterprise of one country has a permanent establishment in the other country at any time during the year, it is deemed to have a permanent establishment in that country for the entire year. This provision would require a Luxembourg enterprise with a permanent establishment in the United States to allocate U.S. source industrial or commercial profits to such permanent establishment in the United States even though the profit may be derived at a time during the taxable year when the permanent establishment was not in existence.

SHIPPING AND AIRCRAFT

The convention provides that income derived from the operation of ships or aircraft registered in either Luxembourg or the United States is to be taxable only in the country in which registered and that income which would otherwise be taxable in the other country will be treated as income from sources within the country of registry (arts. V and XVII).

DIVIDENDS

A reciprocal reduction in rate of tax applicable to dividends received from sources within one country by a resident or corporation of the other country is provided if the dividend recipient does not have a permanent establishment in the source country.

In the case of U.S. residents and corporations receiving dividends from Luxembourg sources, the Luxembourg rate of tax would be reduced from the statutory rate of 15 percent to a treaty rate of 7½ percent. In the case of dividends paid to Luxembourg residents and corporations from U.S. sources, the U.S. rate of tax would be set at a flat 15 percent, without regard to the amount of income the Luxembourg resident or corporation receives from sources within the United States. Therefore, in addition to reducing the U.S. withholding rate on dividends paid Luxembourg residents from 30 to 15 percent, the convention would also have the effect of limiting U.S. tax on dividend income of Luxembourg residents with more than $21,200 of U.S. source income (in taxable years beginning after 1964) to 15 percent rather than at the top tax rate bracket (or brackets) at which the dividend income would otherwise fall on the schedule of graduated rates applicable to income from U.S. sources.

In reducing the tax allocable to the source country, this convention is consistent with other U.S. tax conventions; however, it is unique in that it ties the tax rate to 50 percent of the statutory rates presently in effect, resulting in the aforementioned 15- and 7½-percent rates, rather than permitting variations in rate which would be subject generally to a 15-percent ceiling.

Provision is also made to reduce the source country's rate of tax to 5 percent (rather than the 15- or 7½-percent rates otherwise applicable) if the recipient of the dividend is a corporation which, together with no more than three other 10-percent or more corporation shareholders, owns at least 50 percent of the voting stock of the payor corporation and not more than 25 percent of the payor's gross income consists of dividends and interest from other than 50-percent-owned subsidiaries. Although this provision differs from the majority of U.S. tax conventions by reducing the tax of the source country in cases where the payor is less than 95 percent owned by the recipient, it is substantially identical with provision contained in the U.S. tax convention with Norway and the pending conventions with Japan and Sweden. In general, a lessening of the percentage of ownership required by a corporate shareholder in order to receive the benefits of a reduced withholding rate favors a creditor nation. Therefore, this provision should operate to the benefit of the United States.

As in the case of interest, the convention provides (in art. X) that dividends paid by Luxembourg corporations (other than Luxembourg holding companies) to persons other than U.S. citizens, residents, or corporations will not be taxed by the United States, and dividends paid by U.S. corporations to persons other than Luxembourg residents and corporations will not be taxed by Luxembourg. In the absence of this provision, the United States might otherwise tax the income under the provisions of sections 861(a)(1)(B) and 861(a)(2)(B) of the Internal Revenue Code.

INTEREST

The convention provides that interest, other than interest on debts secured by mortgages on real property, received by a resident or corporation of the United States or Luxembourg would, in general, be taxed only by the country of residence of the recipient if the recipient does not have a permanent establishment in the other country (art. VIII). Thus, the convention adopts the policy contained in the more recent convention to which the United States is a party by, in general, making the country of residence the exclusive taxing jurisidiction, rather than maintaining split jurisdiction to tax, but limiting the authority of the source country through reduction in withholding rates, as is the case under the earlier conventions.

INCOME FROM REAL PROPERTY AND MINERAL ROYALTIES

In general, exclusive jurisdiction to tax income from real property, including gains derived from the sale of real property, mineral royalties, and interest on debts secured by mortgages on real property, is given by the convention to the country in which the property is located, unless, as is the case with all provisions, a country chooses to disregard the convention provision (under art. XVI) but agrees to allow a credit for taxes paid to the country in which the property is located. Moreover, the recipient of the income may elect to be taxed in the source country on the basis of net income from the properties rather than on gross income as would generally be the case for Luxembourg residents and corporations who receive this type of income from sources within the United States but do not engage in trade or business in the United States. This reciprocal provision corresponds to Luxembourg law which permits a U.S. resident or corporation receiving income from real property in Luxembourg to pay tax on a net basis. The convention also contains language which clarifies the position the United States has consistently taken with respect to similar provisions in other conventions to the effect that the election to be taxed on a net income basis applies only to the items of income to which the article (in this case, art. VI) applies.

NONMINERAL ROYALTIES

In general, the convention follows the accepted principle of agreements which seek to eliminate double taxation of income by providing that payments for the use of, or for the privilege of using, property or rights are to be taxed only in the country of residence of the recipient, unless the recipient has a permanent establishment in the country in which the property or right is used.

In this respect, the convention follows prior conventions by specifically providing that income for the privilege of using a copyright, artistic or scientific work, patent, design, plan, secret process or formula, trademark, motion picture film, as well as income from the rental of industrial, commercial, or scientific equipment, is exempt from tax in the source country. This convention adds to the list of items income received for the use of, or for the privilege of using, films or tapes for radio or television broadcasting, and payments for "knowledge, experience, skill, or know-how."

Although income from the use, or for the privilege of using, knowledge, experience, skill, or know-how was not specifically covered in prior conventions, such items of income were treated in the same manner as the items listed if the knowledge, experience, skill, or know-how for which the income was paid was reduced to a form in which it constituted property. This convention excludes such income from tax in the country of use even though the income is paid solely for "knowledge, experience, skill, or know-how" which constitute services, as distinguished from property. In this respect, the convention is to the general advantage of the United States, since U.S. companies presumably supply substantially more services of this type in Luxembourg than Luxembourg corporations furnish in the United States.

COMPENSATION FOR PERSONAL SERVICES

Articles XI, XII, XIII, and XIV follow the usual pattern of income tax conventions in that they—

(1) Exclude compensation, including pensions, paid by one country, or a political subdivision thereof, from income tax in the other country if paid (other than to a citizen of that country) for services rendered in the discharge of governmental functions of the payor country;

(2) Exclude amounts paid as private pensions and life annuities to residents of one country from income tax in the other country if paid from sources within the payor country;

(3) Provide that compensation for labor or personal services performed in one of the contracting countries by a resident of the other country shall be exempt from tax by the country in which the services are performed if the person performing the services is present in that country for 180 days or less during the taxable year and (*a*) the compensation does not exceed $3,000, or (*b*) regardless of the amount of income, the services are performed in one country as an employee of a resident, corporation, or permanent establishment of an enterprise of the other country and the burden of the compensation is borne by such enterprise;

(4) Exempt residents of one country from tax in the other country for a maximum of 2 years if such persons are present in the host country for the purpose of teaching at a recognized educational institution in that country;

(5) Exempt residents of one country from income tax in the other country on income from outside the host country for employment (or remittances from the country of residence to cover cost of maintenance, education, or training in the host country) if present in the host country for the purpose of study or research as a student, business apprentice, or recipient of a grant, allowance, or award from a charitable organization; and

(6) Provide that residents of one country who are present in the other country for not more than 1 year in order to acquire technical, professional, or business experience may exclude up to $5,000 of compensation from tax in the host country (and up to $10,000 if present in the host country under arrangement with the government of that country).

In addition to these provisions, which are found in substantially the same form in other tax conventions to which the United States is a party, the convention expands the exemption generally applicable to teachers (item (4) above) to include persons who engage in research at an educational institution, whether or not the research is conducted in conjunction with teaching duties; however, this exemption does not apply to the extent the research is carried on for the benefit of anyone other than the educational institution which invited the person to the country. Moreover, as noted in item (4), the exemption applies for the first 2 years' salary regardless of how long the person may stay in the host country. This modification of similar provisions contained in prior conventions avoids retroactive tax on income for the first 2 years if, for example, a nonresident alien temporarily present in the United States for the purpose of teaching elects to remain in the United States for a longer period or to become a U.S. citizen. Provision is also made to exclude residents of one country who are present in the other country as students or apprentices from tax in the country in which located as if they were "residents" of that country. Thus, for example, Luxembourg residents who come to the United States for the purpose of attending school will be taxed as nonresident aliens, that is, only on their U.S. source income. In the absence of this provision, such persons often attain resident status in the United States and are taxable in the United States on their worldwide income.

The convention also provides that compensation for labor or personal services performed in one country by a resident of that country shall be exempt from tax in the other country even though the products of the services are put to use in the other country. Thus, for example, a U.S. lawyer who prepares a legal memorandum in the United States for use in Luxembourg will be exempt from Luxembourg tax on the fee he receives for the memorandum. In the absence of this provision, his income would be taxed by both Luxembourg and the United States, since Luxembourg taxes such income on the basis of the place where the product of a personal service is used, as well as on the basis of where the service is performed.

SOURCE OF INCOME RULES

Article XVII contains source of income rules that are more detailed than those set forth in any other treaty to which the United States is a party. In general, these rules adopt the source rules contained in the Internal Revenue Code of 1954 (secs. 861 through 863) and, because of the absence of detailed rules under Luxembourg law, should result in more uniform treatment of items of income so as to avoid double taxation.

FOREIGN TAX CREDITS

The convention provides (in art. XVI) that either the United States or Luxembourg may disregard a provision of the convention and tax any item of income of its citizens (in the case of the United States), residents, and corporations under its revenue laws as if the convention had not come into effect. Thus, if the United States were to tax an item of income without regard to the convention, which it would do in the case of its citizens living in Luxembourg, foreign tax credits would be available to the taxpayer under the provisions of subpart A, part III, of subchapter N of the code (secs. 901 through 905). Therefore, except in the case of Luxembourg citizens resident in the United States, the convention does not extend the circumstances under which credit for Luxembourg income tax, taxes on fees of the directors of corporations, and the communal tax on commercial profits would be available to U.S. taxpayers. However, since Luxembourg, by the convention, agrees to allow credit against Luxembourg tax for taxes paid the United States by U.S. citizens resident in Luxembourg, the reciprocity required by section 901(c)(3) of the code is deemed to be satisfied with the result Luxembourg citizens who are resident in the United States will be allowed credit against their U.S. tax for creditable taxes paid to Luxembourg.

Under Luxembourg law, residents of Luxembourg and corporations managed in Luxembourg do not receive credit for taxes paid a foreign country. However, under the convention, if Luxembourg chooses to disregard a provision of the convention, Luxembourg is required to allow a tax credit for U.S. tax paid by a Luxembourg resident (including U.S. citizens resident in Luxembourg) or corporation in an amount at least equal to that proportion of the Luxembourg tax otherwise payable as income from within the United States which is taxable by Luxembourg bears to the entire income of the taxpayer which is subject to Luxembourg tax. However, Luxembourg is not required to allow a Luxembourg corporation a credit for taxes paid by a 10-percent-owned first-tier subsidiary (or a second-tier corporation 50-percent owned by a 10-percent-owned first-tier subsidiary) from which the Luxembourg corporation receives a taxable dividend. Moreover, the convention does not provide for carrybacks or carryforwards of excess foreign tax credits as is the case under the Internal Revenue Code.

NONAPPLICABILITY TO LUXEMBOURG HOLDING COMPANIES

The convention does not apply to Luxembourg corporations which are now entitled, or subsequently become entitled, to special tax benefits available to companies which do not engage in an active trade or business, so-called holding companies (art. XV). Under present law, these companies are exempt from Luxembourg income tax on the receipt of income, and their shareholders are exempt from Luxembourg tax on the receipt of dividends from these companies.

In general, the purpose of an income tax convention is to prevent income from sources within one country which is received by a resident of another country from being taxed twice, first in the country in which the income is derived and a second time in the country in which the recipient resides. Consistent with this philosophy, this convention follows the pattern of most other income tax conventions to which the United States is a party, as above described, by providing that interest and nonmineral royalty income is to be completely exempt from tax in the source country, and that dividend income is to be subject to a reduced rate of tax in the source country. Thus, for example, although dividend, interest, or royalty income from sources within the United States which is received by a resident of Luxembourg is exempt from U.S. tax, or subject to U.S. tax at reduced rates, the income is generally subject to full Luxembourg tax when received by a Luxembourg resident. However, if income were received by a Luxembourg holding company whose shareholders reside in a third country, and the provisions of this convention were made applicable to such companies, it would be possible for interest and royalty income to be completely exempt from tax in the United States, in Luxembourg, and also in the country of residence of the corporate shareholder if the third country in which the shareholder resides does not have an income tax. Moreover, the reduced U.S. tax rate on dividends would be the sole tax burden on dividend income.

A hypothetical example may illustrate this point. Under present law, if a resident of the Bahamas invested directly in the United States, he would be subject to U.S. tax at a 30-percent rate on dividends, interest, and royalty income from sources within the United States if his total income from sources within the United States did not exceed $19,000 a year ($21,200 for taxable years beginning after 1964) and would be subject to the graduated rates applicable to U.S. citizens and residents generally if his income exceeded that amount. Since the Bahamas does not have an income tax, the U.S. tax would be the sole tax burden on the U.S. source income. Moreover, under present law, there would be little inducement for a resident of the Bahamas to invest in the United States through a Luxembourg holding company, since payments to the Luxembourg holding company would be subject to a 30 percent U.S. withholding rate, and, if the Luxembourg holding company received 50 percent or more of its gross income for the 3-year period ending with the close of its taxable year preceding the declaration of a dividend from sources within the United States, a portion of the dividends paid by the Luxembourg holding company to its shareholders would also be treated for U.S. tax purposes as income from sources within the United States. In such a case, the Bahamian resident would again (theoretically, but perhaps not practically) be subject to U.S. tax at a 30-percent rate or at graduated rates if his U.S. source income exceeded the prescribed $19,000 or $21,200 amount. However, if the convention were made applicable to Luxembourg holding companies, persons such as the Bahamian resident would be encouraged to make U.S. investments through a Luxembourg holding company so as to receive the benefit of the U.S. exemption from tax on interest and royalty income, and the reduction of tax on dividend income, as well as the benefits of article X(1) of the convention which insulates a resident of a third country from U.S. tax on receipt of dividends from Luxembourg corporations by providing that the United States will not tax the dividend or interest income of a resident of a third country which is received from a Luxembourg corporation. Thus, to prevent complete or substantial elimination of tax on U.S. source dividend, interest, and royalty income received by residents of low tax rate third countries, the convention is made inapplicable to Luxembourg holding companies. In effect, residents of third countries retain their present tax position.

Since the use of Luxembourg holding companies to invest in the United States has not been widespread (even though the law granting the special tax benefits was first enacted in 1929), denial of the convention benefits to these companies should not adversely affect the U.S. balance-of-payments position. It should be noted, however, that denial of the convention benefits with respect to dividends and interest paid by a Luxembourg holding company to its shareholders, so-called secondary liability, is inconsistent with the treatment afforded shareholders of Netherlands Antilles corporations under similar circumstances in the protocol dated October 23, 1963, modifying and supplementing the extension to the Netherlands Antilles of the income tax convention with the Netherlands.

UNILATERAL RELIEF FROM LUXEMBOURG WEALTH TAX AND COMMUNAL TAXES ON LAND, COMMERCIAL PROFITS, AND INVESTED CAPITAL

Wealth tax.—Under Luxembourg law, residents of Luxembourg, and corporations having their principal seat of management in Luxembourg, are, in general, subject to a wealth tax imposed at a rate of 0.5 percent of net worth based upon the value of property wherever situated. Nonresidents of Luxembourg, and corporations managed outside of Luxembourg, are similarly taxed on the value of the net worth of their Luxembourg property. Under article XVI(2)(c) of the convention, Luxembourg agrees to exempt real property situated in the United States, debts secured by real property situated in the United States, and all or a portion of the invested capital of a permanent establishment situated in the United States from the determination of the net worth of its residents and corporations.

Communal tax on land.—Under Luxembourg law, real property located in Luxembourg is subject to tax based on the property's assessed valuation. Although a national tax, the tax is collected by, and for the benefit of, local municipalities. Article XVI(2)(a) of the convention provides that Luxembourg will not extend the scope of the tax so as to tax real property situated in the United States.

Communal taxes on commercial profits and invested capital.—Under Luxembourg law, commercial profits of a business enterprise, other than profits allocable to a fixed place of business outside of Luxembourg, are, in general, subject to tax at a flat rate of 4 percent. Moreover, business enterprises are subject, in general, to tax at a flat rate of 0.2 percent on capital, other than that portion allocable to a fixed place of business outside of Luxembourg. Both these taxes are levied for the benefit of local municipalities who are authorized to adjust the basic tax rates. Article XVI(2)(b) of the convention provides that Luxembourg will exempt from tax profits and invested capital allocable to a permanent establishment located in the United States. To the extent a permanent establishment, as defined in the convention, is broader than the Luxembourg definition of a "fixed place of business," additional profits and capital of business enterprises subject to these taxes will be exempt.

TAX ON FEES OF DIRECTORS OF LUXEMBOURG CORPORATIONS

Under Luxembourg law, directors of corporations managed in Luxembourg are subject to a special tax on fees paid to them as directors of such corporations. In the case of directors who are nonresidents of Luxembourg, liability for tax, and the amount withheld at source, is fixed at 28 percent of the gross fee. Provision is made in the convention to exclude compensation of this type from the provisions that otherwise apply to income for personal services. Thus, Luxembourg retains its jurisdiction to tax such income, while the United States agrees to grant its residents and citizens a credit against U.S. tax otherwise payable for the Luxembourg tax withheld. This treatment of taxation of directors' fees, which retains tax jurisdiction in the source country, is consistent with the model convention being prepared by the Fiscal Committee of the OECD.

ADMINISTRATIVE PROVISIONS

In addition to the above-described provisions, the convention contains articles similar to those of other conventions which, in general (1) provide for the exchange of information necessary to carry out the provisions of the convention and to prevent fraud and tax avoidance; (2) establish a procedure whereby a taxpayer may appeal an action of the United States or Luxembourg which he shows results in double taxation in violation of the convention; and (3) requires that neither the United States nor Luxembourg is to impose more burdensome taxes on citizens of the other country than it imposes upon its own residents. Provision is also made to allow the competent authorities of Luxembourg and the United States to prescribe regulations necessary to carry out the provisions of the convention.

EFFECTIVE DATE

The convention is effective for taxable years beginning on or after January 1 of the calendar year following the year in which the convention is ratified and the instruments of ratification are exchanged. The convention is effective for a period of 5 years, and indefinitely thereafter, but may be terminated by either country at the end of the 5-year period, or at any time thereafter provided 6 months' notice of termination is given.

TAX CONVENTION WITH THE NETHERLANDS

The protocol dated October 23, 1963, would modify the tax convention with the Netherlands dated April 29, 1948, as supplemented by a protocol signed at Washington on June 15, 1955, which extended most of the provisions in the 1948 convention to the Netherlands Antilles.

NONAPPLICABILITY (IN PART) TO NETHERLANDS ANTILLES HOLDING COMPANIES

In general, the major proposition involved in this convention is essentially the same as that presented in the provision of the pending Luxembourg convention (art. XV) which would deny the benefits of that convention to so-called Luxembourg holding companies. In essence, it is the question of the extent to which residents of countries other than the contracting countries should be allowed to use the provisions of a tax convention to reduce or eliminate U.S. and/or overall income tax on dividend, interest, and royalty income derived from sources within the United States.

The context of the situations in which this matter arises under the tax convention with the Netherlands, as it applies to the Netherlands Antilles, involves the interrelationship of four factors. First, the fact that the present convention (in art. VII, VIII, and IX) provides, in general, (*a*) for a reduction of U.S. tax on U.S. source dividends payable to Netherlands Antilles corporations to 15 percent (5 percent in the case of 95-percent-owned subsidiaries) and (*b*) an exclusion from U.S. tax on U.S. source interest and nonmineral royalties. Second, the fact that under a special tax law in the Netherlands Antilles (art. 13, 14, and 14(a) of the Netherlands Antilles' National Ordinance on Profit Tax of 1940), the Netherlands Antilles limits its tax to 3 percent on dividend, interest, and royalty income of so-called Netherlands Antilles holding companies, in lieu of the 30-percent rate otherwise applicable (2.4-percent rate on approximately the first $50,000 of income in lieu of the 24-percent rate otherwise applicable). Third, the fact that the present convention (art. XII) provides that the United States will not tax dividends and interest paid by a Netherlands Antilles corporation to residents of third countries. Fourth, the fact that individuals resident outside the United States and the Netherlands Antilles may not pay income tax to the country in which they are resident on U.S. source income either because the country of their residence may not impose an income tax or the individuals do not report U.S. source income in that country.

The effect these factors may have on the U.S. and overall tax on U.S. source dividend, interest, and royalty income may be illustrated by assuming that an individual who is neither a citizen nor resident of the United States or the Netherlands Antilles invests in the United States through the use of a Netherlands Antilles corporation. On this basis, dividend income received by the Netherlands Antilles corporation from sources within the United States would be subject to a 15-percent U.S. tax (5 percent in the case of dividends received from 95-percent-owned U.S. subsidiaries), while interest and royalty income received by the corporation from U.S. sources would be exempt from U.S. tax (point 1). The Netherlands Antilles corporation would be subject to a 3-percent Netherlands Antilles tax on its income (point 2). There would be no United States or Netherlands Antilles tax on the nonresident alien on the receipt of a dividend from the Netherlands Antilles corporation (point 3), and the dividend would be tax exempt in the country of the recipient's residence (point 4). Thus, it is apparent that the U.S. and overall tax burden of an individual resident in a country with which the United States does not have a tax convention could, by employing the above-described pattern of investment, be substantially reduced when compared with alternative methods of investing in the United States. In the case of U.S. source dividend income, the overall rate of tax would be approximately 17.55 percent (15 percent United States tax and 2.55 percent Netherlands Antilles tax (3 percent on 85 percent of the gross dividend)), while the overall tax rate on interest and royalty income would be limited to 3 percent Netherlands Antilles tax. These 17.55- percent and 3-percent rates compare favorably with the 30 percent or greater U.S. tax rate applicable to nonresident aliens in the absence of the present convention.

The pending protocol would change the above-described pattern in one respect; that is, it would, in general, increase the U.S. tax payable on the payment of dividends, interest, and nonmineral royalties to Netherlands Antilles corporations to 30 percent of the gross payment from the 15 and zero percent rates presently applicable. Thus, the U.S. and overall tax burden will be increased from 17.55 percent on dividend income, and 3 percent on interest and nonmineral royalty income, to approximately 32 percent (30 percent United States tax and 3 percent Netherlands Antilles tax on 70 percent of the gross dividend).

The pending protocol would not change the present 15 and zero percentage rates on U.S. source dividends, interest and nonmineral royalties paid to Netherlands Antilles corporations if (*a*) the recipient corporation is 100-percent owned by (1) residents of the Netherlands, (2) Netherlands corporations, or (3) residents of the Netherlands Antilles; or (*b*) the income is received by a Netherlands Antilles corporation from a 25-percent-owned U.S. subsidiary corporation if less than 60 percent of the payor's gross income consists of passive income.

It should be noted that no change in the present convention is proposed so as to permit the United States to assert its statutory authority to impose U.S. tax on the shareholders of a Netherlands Antilles corporation at a 30 percent or greater rate if the Netherlands Antilles corporation received 50 percent or more of its gross income from U.S. sources for the 3-year period ending with the date of its taxable year preceding the declaration of a dividend. Although it would be consistent with the approach taken in the pending Luxembourg convention to make article XII of the convention with the Netherlands inapplicable in the case of dividends paid by Netherlands Antilles corporations to nonresident shareholders, to do so could cause an adverse effect on the U.S. balance-of-payments position. Since it is estimated that a large portion of the assets held by Netherlands Antilles corporations (estimated at approximately $1 billion) is held by corporations which derive 50 percent or more of their gross income from sources within the United States, it is feared that repeal of article XII could cause a substantial liquidation of U.S. assets held by these corporations so as to avoid the statutory 50-percent rule which would be applicable in the absence of the present convention.

INCOME FROM PROPERTY AND MINERAL ROYALTIES

Under the present convention, a resident, or corporation or other entity of one of the contracting countries who receives mineral royalties, or income from real property, from sources within the other country may elect to be taxed in the source country on a net income basis. The pending protocol makes it clear that the election to be taxed on a net basis applies only to income from real property and royalties in respect of the operation of mines, quarries, or other natural resources.

EFFECTIVE DATE

In general, the proposed changes increasing U.S. tax to 30 percent would be effective with respect to royalty payments made on or after January 1 of the year following the year in which the exchange of instruments of ratification takes place and at the same time for dividend, interest, and royalty payments made to Netherlands Antilles corporations organized after May 14, 1963. The proposed changes would, however, only apply to interest paid after December 31, 1966, to a Netherlands Antilles corporation which was organized before May 15, 1963; moreover, dividends paid to such Netherlands Antilles corporations would continue to be subject to the present 15-percent rate for payments made during calendar years 1964 and 1965, to a 20-percent rate for payments made during calendar year 1966, and at the proposed 30-percent rate only with respect to payments made after December 31, 1966.

INCOME TAX CONVENTION WITH SWEDEN

The supplementary convention dated October 22, 1963, would modify and supplement the convention between the United States and Sweden signed at Washington on March 23, 1939.

BUSINESS PROFITS

Under the present convention, a business enterprise of one country is taxable on its industrial and commerical profits in the other country only if it maintains a permanent establishment in the other country. For this purpose, the term "permanent establishment" is presently defined as a branch, mine, oil well, plantation, factory, workshop, warehouse, office, agency, or other fixed place of business. The pending supplementary convention would replace this definition with the definition contained in the draft convention for the avoidance of double taxation approved by the Fiscal Committee of the Organization for Economic Cooperation and Development (OECD). As noted in the explanation of the pending Luxembourg convention, which, in general, also adopts the OECD definition, the new definition is most significant in that it itemizes a series of activities which could not be treated as constituting a "permanent establishment." The result is that it permits an enterprise of one country to economically penetrate the other country to a greater degree than has heretofore been provided in the tax conventions to which the United States is a party without incurring tax in the host country. As in the convention with Luxembourg, an enterprise of one country maintaining a permanent establishment in the other country would be subject to tax in the host country in respect of its industrial and commercial profits only on such profits which are "allocable to" the permanent establishment.

DIVIDENDS

Under the present convention, U.S. citizens, residents and corporations receiving dividends from Swedish corporations are subject to a 10-percent Swedish tax, withheld at source, in lieu of the 30-percent Swedish tax otherwise applicable. Similarly, U.S. tax on dividends paid to Swedish residents and corporations by U.S. corporations is limited under the present convention to 10 percent of the gross dividend, in lieu of the minimum U.S. 30-percent rate otherwise applicable. The pending supplementary convention would increase the tax in the source country from 10 to 15 percent and thus bring the source country rate in line with that provided in most other income tax conventions to which the United States is a party. However, provision is made to reduce the source country's rate of tax to 5 percent (rather than the 15-percent rate otherwise applicable) if the recipient of the dividend is a corporation which, together with no more than three other 10-percent or more corporate shareholders, owns at least 50 percent of the voting stock of the payer corporation, and not more than 25 percent of the payer's gross income consists of dividends and interest from other than 50-percent-owned subsidiaries. This provision is similar to that contained in the U.S. tax convention with Norway and in the pending conventions with Luxembourg and Japan.

The pending convention also provides that dividends received by Swedish corporations from U.S. corporations would, in general, be exempt from corporate tax in Sweden.

INTEREST

Under the present convention, interest on bonds, debentures, and other forms of indebtedness received from sources within one of the contracting countries by a resident or corporation or other entity of the other country is subject to tax in the source country at the normal withholding rate applicable in the source country on interest income payable to nonresident aliens. Thus, at the present time, the United States withholds tax at a 30-percent rate on U.S.-source interest paid to Swedish residents and corporations. However, since Sweden exempts Swedish source interest payable to nonresident aliens from tax in Sweden, U.S. citizens, residents and corporations are, at present, exempt from tax in Sweden on their Swedish source interest income.

The pending supplementary convention would provide for the exclusion of interest income from tax in the source country on a reciprocal basis. In this respect, the pending convention adopts the policy contained in the more recent income tax conventions to which the United States is a party by, in general, making the country of residence the exclusive taxing jurisdiction for interest income.

COMPENSATION FOR PERSONAL SERVICES

Under the present convention, students and business apprentices from one country who are present in the other country to study or to acquire business experience are exempt from tax in the host country on remittances received from their home country if the remittance is used for their maintenance or studies. The pending supplementary convention extends the circumstances under which persons from one country may be temporarily present in the other country for an education related purpose without being taxable in the host country. In general, the additional exemptions correspond to provisions contained in the more recent income tax conventions to which the United States is a party and may be summarized as follows: Residents of one country would be exempt from tax in the other country for a period of 2 years on compensation received for teaching or conducting research (other than for research carried on for profit) at an educational institution situated in the other country; an exclusion from tax would be provided in the host country for compensation for employment remitted from the other country to a student or business apprentice without regard to the use made of the remittances by the recipient; recipients of grants, allowances, or awards from religious, charitable, scientific, or educational organizations for the primary purpose of study or research would be exempt from tax in the host country on the same basis as remittances to students and business apprentices; and remuneration received by a resident of one of the contracting countries temporarily present in the other country solely for the purpose of training, research, or study would be exempt from tax in the host country if (*a*) he is present in the host country under an arrangement with the government of that country, (*b*) the total amount of the remuneration does not exceed $10,000 and (*c*) the remuneration is directly related to the training, research or study undertaken.

FOREIGN TAX CREDITS

Under the present convention, as in other income tax conventions to which the United States is a party, the contracting countries each retain the right to tax the income of their citizens, residents, and corporations as though the convention had not come into effect. However, to relieve double taxation of income in these cases, the conventions generally provide for the allowance of a tax credit in the country of the taxpayer's residence for income taxes paid the other country.

Since the statutory law of Sweden does not provide for crediting U.S. tax paid by Swedish residents or corporations against Swedish tax liability, the present convention requires Sweden to grant its residents and corporations a foreign tax credit for U.S. tax paid on U.S. source income which would otherwise be exempt from tax in Sweden under the convention. Thus, in effect, a credit for taxes paid directly by the taxpayer, on a per-country basis, is allowed with respect to income exempt from tax in Sweden under the convention. However, if the income is taxable both in the United States and Sweden, U.S. tax is allowable as a credit against Swedish tax only in the case of dividend income; moreover, the credit is limited to 5 percent of the gross dividend, although the actual U.S. tax paid is 10 percent of the gross dividend. Under the present convention, no relief from double taxation is provided in other cases where the same income is taxable both in the United States and Sweden (for example, in the case of Swedish corporations which derive industrial and commercial profits in the United States through a permanent establishment located in the United States or U.S.-source interest income).

In the case of Swedish residents or corporations deriving U.S.-source income, the pending supplementary convention would provide more effective relief from double taxation in two ways:

First, income which under the convention is exempt from tax in Sweden (for example, U.S.-source interest, rent, mineral royalties, shipping income, wages paid by the United States to Swedish residents, and certain pensions) would be exempt from tax in Sweden. However, the income would be taken into account in computing the Swedish resident's or corporation's effective Swedish tax rate. This method of treatment, the so-called exclusion method, has been recognized by the Organization for Economic Cooperation and Development (OECD) as an appropriate method for the relief from double taxation of income and has been adopted by the United States in its tax conventions with Germany and Switzerland.

Second, in the case of income which under the convention is taxable both in the United States and Sweden (for example, U.S.-source industrial or commercial profits and dividends), the pending supplementary convention would adopt the more generally utilized tax credit method for the relief from double taxation and would require that a credit be allowed against Swedish tax for U.S. tax paid by Swedish residents and corporations on their U.S. source income.

The credit would, of course, be limited to that proportion of the Swedish tax otherwise payable which the U.S.-source income which is taxable under the convention in both the United States and Sweden bears to the taxpayer's entire income subject to tax in Sweden.

The pending supplementary convention would also provide that the United States would allow a tax credit for Swedish taxes paid by its citizens, residents, or corporations in accordance with the internal revenue laws of the United States in effect for the taxable year in which the dividend is received, rather than in accordance with the U.S. statutory foreign tax credit provisions in effect in 1939 when the present convention was ratified.

EFFECTIVE DATE

In general, the pending supplementary convention would be effective for taxable years beginning on or after January 1, 1963. However, the provision relating to the taxation of dividends in the source country at a 15-percent rate (5 percent in the case of certain closely held corporations), in lieu of the present 10-percent rate, would be effective for taxable years beginning after January 1 of the year in which instruments of ratification are exchanged.

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