105TH CONGRESS 1st Session | SENATE | EXEC. RPT. 105–11

TAX CONVENTION WITH SOUTH AFRICA

OCTOBER 30, 1997.—Ordered to be printed

Mr. HELMS, from the Committee on Foreign Relations, submitted the following

REPORT

[To accompany Treaty Doc. 105–9]

The Committee on Foreign Relations, to which was referred the Convention between the United States of America and the Republic of South Africa for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, signed at Cape Town February 17, 1997, having considered the same, reports favorably thereon, with one declaration and one proviso, and recommends that the Senate give its advice and consent to ratification thereof, as set forth in this report and the accompanying resolution of ratification.

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I. PURPOSE

The principal purposes of the proposed income tax treaty between the United States and South Africa are to reduce or eliminate double taxation of income earned by residents of either country from sources within the other country and to prevent avoidance or evasion of the income taxes of the two countries. The proposed treaty is intended to promote close economic cooperation and facilitate trade and investment between the two countries. It also is intended to enable the two countries to cooperate in preventing avoidance and evasion of taxes.

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II. Background

The proposed treaty was signed on February 17, 1997. No income tax treaty between the United States and South Africa is in force at present. The income tax treaty between the United States and South Africa that was signed in 1946 was terminated on July 1, 1987.

The proposed treaty was transmitted to the Senate for advice and consent to its ratification on June 26, 1997 (see Treaty Doc. 105-9). The Committee on Foreign Relations held a public hearing on the proposed treaty on October 7, 1997.

III. Summary

The proposed treaty is similar to other recent U.S. income tax treaties, the 1996 U.S. model income tax treaty ("U.S. model"),[1] and the model income tax treaty of the Organization for Economic Cooperation and Development ("OECD model"). However, the proposed treaty contains certain substantive deviations from those documents.

As in other U.S. tax treaties, the proposed treaty's objective of reducing or eliminating double taxation principally is achieved by each country agreeing to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other country. For example, the proposed treaty contains provisions under which neither country generally will tax business income derived from sources within that country by residents of the other country unless the business activities in the taxing country are substantial enough to constitute a permanent establishment or fixed base (Articles 7 and 14). Similarly, the proposed treaty contains "commercial visitor" exemptions under which residents of one country performing personal services in the other country will not be required to pay tax in the other country unless their contact with the other country exceeds specified minimums (Articles 14, 15, and 17). The proposed treaty provides that dividends and certain capital gains derived by a resident of either country from sources within the other country generally may be taxed by both countries (Articles 10 and 13); however, the rate of tax that the source-country may impose on a resident of the other country on dividends generally will be limited by the proposed treaty (Article 10). The proposed treaty also provides that interest and royalties derived by a resident of either country generally will be exempt from tax in the other country (Articles 11 and 12).

In situations where the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the proposed treaty generally provides for relief from the potential double taxation through the allowance by the country of residence of a tax credit for certain foreign taxes paid to the other country (Article 23).

The proposed treaty includes the "saving clause" contained in U.S. tax treaties that allows the United States to retain the right to tax its citizens and residents as if the treaty had not come into

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

effect (Article 1). In addition, the proposed treaty contains the standard provision that it may not be applied to deny any taxpayer any benefits the taxpayer would be entitled to under the domestic law of a country or under any other agreement between the two countries (Article 1).

The proposed treaty also contains a detailed limitation on benefits provision to prevent the inappropriate use of the treaty (Article 22).

IV. Entry Into Force and Termination

A. ENTRY INTO FORCE

The proposed treaty provides that the countries must notify each other that the constitutional requirements for the entry into force of the proposed treaty have been complied with.

The proposed treaty will enter into force thirty days after the date on which the second of the two notifications of the completion of the constitutional requirements has been received. With respect to taxes payable at source, the proposed treaty will be effective for amounts paid or credited on or after the first of January following entry into force. With respect to other taxes, the proposed treaty will be effective for taxable periods beginning on or after such first of January.

B. TERMINATION

The proposed treaty will continue in force until terminated by either country. Either country may terminate the proposed treaty by giving notice through diplomatic channels at least six months before the end of any calendar year starting five years after the year the treaty has entered into force. With respect to taxes payable at source, a termination will be effective for amounts paid or credited on or after the first of January following the year in which notice of termination is given. With respect to other taxes, a termination will be effective for taxable periods beginning on or after the first of January following the year in which such notice of termination is given.

V. Committee Action

The Committee on Foreign Relations held a public hearing on the proposed treaty with South Africa (Treaty Doc. 105-9), as well as on other proposed tax treaties and protocols, on October 7, 1997. The hearing was chaired by Senator Hagel. The Committee considered these proposed treaties and protocols on October 8, 1997, and ordered the proposed treaty with South Africa favorably reported by a voice vote, with the recommendation that the Senate give its advice and consent to ratification of the proposed treaty, subject to a declaration and a proviso.

VI. Committee Comments

On balance, the Committee on Foreign Relations believes that the proposed treaty with South Africa is in the interest of the United States and urges that the Senate act promptly to give advice and consent to ratification. The Committee has taken note of certain issues raised by the proposed treaty, and believes that the following comments may be useful to Treasury Department officials in providing guidance on these matters should they arise in the course of future treaty negotiations.

A. TREATMENT OF REIT DIVIDENDS

REITs in general

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

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

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

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

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

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

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

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

Foreign investors in REITs

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

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

U.S. income tax treaties contain provisions limiting the amount of income tax that may be imposed by one country on residents of the other country. Many treaties, like the proposed treaty, generally allow the source country to impose not more than a 15-percent withholding tax on dividends paid to a resident of the other treaty country. In the case of real estate income, most treaties, like the proposed treaty, specify that income derived from, and gain from dispositions of, real property in one country may be taxed by the country in which the real property is situated without limitation.[2] Accordingly, U.S. real property rental income derived by a resident of a treaty partner generally is subject to the U.S. withholding tax at the full 30-percent rate (unless the net-basis taxation election is made), and U.S. real property gains of a treaty partner resident are subject to U.S. tax in the manner and at the rates applicable to U.S. persons.

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

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

Beginning in 1989, U.S. treaty negotiators began including in treaties provisions excluding REIT dividends from the reduced rates of withholding tax generally applicable to dividends. Under treaties with these provisions such as the proposed treaty, REIT dividends generally are subject to the full U.S. 30-percent withholding tax.[3]

Analysis of treaty treatment of REIT dividends

The specific treaty provisions governing REIT dividends were introduced beginning in 1989 because of concerns that the reductions in withholding tax generally applicable to dividends were inappropriate in the case of dividends from REITs. The reductions in the rates of source-country tax on dividends reflect the view that the full 30-percent withholding tax rate may represent an excessive rate of source-country taxation where the source country already has imposed a corporate-level tax on the income prior to its distribution to the shareholders in the form of a dividend. In the case of dividends from a REIT, however, the income generally is not subject to corporate-level taxation.

[2] Many treaties allow the foreign person to elect to be taxed in the source country on income derived from real property on a net basis under the source country's domestic laws.

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

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

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

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

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

At the October 7, 1997 hearing on the proposed treaty (as well as other proposed treaties and protocols), the Treasury Department announced that it has modified its policy with respect to the exclusion of REIT dividends from the reduced withholding tax rates applicable to other dividends under treaties. The Treasury Department worked extensively with the staff of the Committee on Foreign Relations, the staff of the Joint Committee on Taxation, and representatives of the REIT industry in order to address the concern that the current treaty policy with respect to REIT dividends may discourage some foreign investment in REITs while maintaining a treaty policy that properly preserves the U.S. taxing jurisdiction over foreign direct investment in U.S. real property. The new policy is a result of significant cooperation among all parties to balance these competing considerations.

Under this policy, REIT dividends paid to a resident of a treaty country will be eligible for the reduced rate of withholding tax applicable to portfolio dividends (typically, 15 percent) in two cases. First, the reduced withholding tax rate will apply to REIT dividends if the treaty country resident beneficially holds an interest of 5 percent or less in each class of the REIT's stock and such dividends are paid with respect to a class of the REIT's stock that is publicly traded. Second, the reduced withholding tax rate will apply to REIT dividends if the treaty country resident beneficially holds an interest of 10 percent or less in the REIT and the REIT is diversified, regardless of whether the REIT's stock is publicly traded. In addition, the current treaty policy with respect to the application of the reduced withholding tax rate to REIT dividends paid to individuals holding less than a specified interest in the REIT will remain unchanged.

For purposes of these rules, a REIT will be considered diversified if the value of no single interest in real property held by the REIT exceeds 10 percent of the value of the REIT's total interests in real property. An interest in real property will not include a mortgage, unless the mortgage has substantial equity components. An interest in real property also will not include foreclosure property. Accordingly, a REIT that holds exclusively mortgages will be considered to be diversified. The diversification rule will be applied by looking through a partnership interest held by a REIT to the underlying interests in real property held by the partnership. Finally, the reduced withholding tax rate will apply to a REIT dividend if the REIT's trustees or directors make a good faith determination that the diversification requirement is satisfied as of the date the dividend is declared.

The Treasury Department will incorporate this new policy with respect to the treatment of REIT dividends in the U.S. model treaty and in future treaty negotiations.

The Committee believes that the new policy with respect to the applicability of reduced withholding tax rates to REIT dividends appropriately reflects economic changes since the establishment of the current policy. The Committee further believes that the new policy fairly balances competing considerations by extending the reduced rate of withholding tax on dividends generally to dividends paid by REITs that are relatively widely-held and diversified. The Committee anticipates that incorporation of this new policy will be considered in connection with any future modification to the proposed treaty.

B. TREATY SHOPPING

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

The anti-treaty-shopping provision of the proposed treaty is similar to an anti-treaty-shopping provision in the Internal Revenue Code (the "Code"), as interpreted by Treasury regulations, and in several newer treaties. Some aspects of the provision, however, differ from an anti-treaty-shopping provision in the U.S. model treaty.

One provision of the anti-treaty-shopping article differs from the comparable rule in some earlier U.S. treaties, but the effect of the change is not completely clear. The general test applied by those earlier treaties for the allowance of benefits, short of satisfaction of a bright-line ownership and base erosion test, is a broadly subjective one, looking to whether the acquisition, maintenance, or operation of an entity did not have "as a principal purpose obtaining benefits" under the treaty. By contrast, the proposed treaty contains a more precise test that allows denial of benefits only with respect to income not derived in connection with the active conduct of a trade or business. (However, this active trade or business test generally does not apply with respect to a business of making or managing investments, so benefits can be denied with respect to such a business regardless of how actively it is conducted.) In addition, the proposed treaty gives the competent authority of the source country the ability to override this standard and to allow benefits if it so determines in its discretion.

The practical difference between the proposed treaty tests and the earlier tests will depend upon how they are interpreted and applied. The principal purpose test may be applied leniently (so that any colorable business purpose suffices to preserve treaty benefits), or it may be applied strictly (so that any significant intent to obtain treaty benefits suffices to deny them). Similarly, the standards in the proposed treaty could be interpreted to require, for example, a more active or a less active trade or business (though the range of interpretation is far narrower). Thus, a narrow reading of the principal purpose test could theoretically be stricter than a broad reading of the proposed treaty test (i.e., would operate to deny benefits in potentially abusive situations more often).

As part of its consideration of the proposed treaty, the Committee asked the Treasury Department about the adequacy of the anti-treaty-shopping provision in the proposed treaty. The relevant portion of the Treasury Department's October 8, 1997 letter [4] responding to this inquiry is reproduced below:

The limitation on benefits article in the South African treaty is very close to that in the U.S. model. It differs in two principal respects related to the tax laws and

[4] Letter from Joseph H. Guttentag, International Tax Counsel, Treasury Department, to Senator Paul Sarbanes, Committee on Foreign Relations, October 8, 1997.

policies of each country, both of which tighten the provision. Accordingly, we believe that it deals more than adequately with possible treaty-shopping abuses.

The first difference is that it contains a provision, included at South Africa's request, under which trusts will be granted benefits under the ownership/base erosion tests only if they meet stricter standards than those applicable to entities other than trusts. The other principal difference from the Model provision is the inclusion of a so-called triangular case provision, which is included in all cases in which the treaty partner does not tax the earnings of a resident that are earned through a branch in a third country. The triangular case provision in the South African treaty is nearly identical to the provision in all of our other treaties with exemption countries. It provides that a South African entity that establishes a branch in a third country generally will not be entitled to benefits under the convention with respect to any item of income unless the combined tax imposed by both South Africa and the third country on that income totals at least 50% of the tax that would be imposed by South Africa if the income were not earned through the third country branch. This is a significant limitation on benefits, included in new treaties with countries that have an exemption system, under which the income of a resident earned through a third country branch generally is not taxed. The provision embodies the view that if the third country imposes low or no taxes, treaty benefits generally are inappropriate.

The Committee believes that limitation on benefits provisions are important to protect against "treaty shopping" by limiting benefits of a treaty to bona fide residents of the treaty partner. The Committee continues to believe that the United States should maintain its policy of limiting treaty shopping opportunities whenever possible. The Committee continues to believe further that, in exercising any latitude Treasury has to adjust the operation of the proposed treaty, the rules as applied should adequately deter treaty shopping abuses. The anti-treaty-shopping provision in the proposed treaty may be effective in preventing third-country investors from obtaining treaty benefits by establishing investing entities in South Africa since third-country investors may be unwilling to share ownership of such investing entities on a 50-50 basis with U.S. or South African residents or other qualified owners to meet the ownership test of the anti-treaty-shopping provision. In addition, the base erosion test provides protection from certain potential abuses of a South African conduit. Moreover, the proposed treaty includes an anti-abuse rule covering the so-called "triangular case." This rule generally permits the United States to impose a 15 percent tax on interest and royalties paid to a low-taxed third-country branch of a South African company and to tax other payments to such branch in accordance with U.S. internal law. An exception from this rule is provided if the third-country income is subject to taxation by the United States under the subpart F controlled foreign corporation provisions of the Code. Finally, South Africa imposes significant taxes of its own; these taxes may deter third-country investors from seeking to use South African entities to make U.S. investments. On the other hand, implementation of the detailed tests for treaty shopping set forth in the proposed treaty may raise factual, administrative, or other issues that cannot currently be foreseen. The Committee emphasizes that the proposed anti-treaty-shopping provision must be implemented so as to serve as an adequate tool for preventing possible treaty-shopping abuses in the future.

VII. Budget Impact

The Committee has been informed by the staff of the Joint Committee on Taxation that the proposed treaty is estimated to cause a negligible change in fiscal year Federal budget receipts during the 1998-2007 period.

VIII. Explanation of Proposed Treaty

A detailed, article-by-article explanation of the proposed income tax treaty between the United States and South Africa is presented below.

Article 1. General Scope

The proposed treaty generally applies to residents of the United States and to residents of South Africa, with modifications to such scope provided in other articles (e.g., Article 19 (Government Service), Article 24 (Non-discrimination) and Article 26 (Exchange of Information and Administrative Assistance)).

The proposed treaty provides that it generally does not restrict any benefits accorded by internal law or by any other agreement between the United States and South Africa. Thus, the proposed treaty applies only where it benefits taxpayers. As discussed in the Treasury Department's Technical Explanation of the proposed treaty (hereinafter referred to as the "Technical Explanation"), the fact that the proposed treaty only applies to a taxpayer's benefit does not mean that a taxpayer could inconsistently select among treaty and internal law provisions in order to minimize its overall tax burden. The Technical Explanation sets forth the following example. Assume a resident of South Africa has three separate businesses in the United States. One business is profitable, and constitutes a U.S. permanent establishment. The other two are trades or businesses that would generate effectively connected income as determined under the Code, but that do not constitute permanent establishments as determined under the proposed treaty; one trade or business is profitable and the other generates a net loss. Under the Code, all three operations would be subject to U.S. income tax, in which case the losses from the unprofitable line of business could offset the taxable income from the other lines of business. On the other hand, only the income of the operation which gives rise to a permanent establishment would be taxable by the United States under the proposed treaty. The Technical Explanation makes clear that the taxpayer could not invoke the proposed treaty to exclude the profits of the profitable trade or business that does not constitute a permanent establishment and invoke U.S. internal law to claim the loss of the unprofitable trade or business that does not constitute a permanent establishment against the taxable income of the permanent establishment.[5]

The proposed treaty provides that its dispute resolution procedures under the mutual agreement article take precedence over the corresponding provisions of any other agreement between the United States and South Africa in determining whether a law or other measure is within the scope of the proposed treaty. Unless the com-

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

petent authorities agree that the law or other measure is outside the scope of the proposed treaty, only the proposed treaty's nondiscrimination rules, and not the nondiscrimination rules of any other agreement in effect between the United States and South Africa, generally apply to that law or other measure. For these purposes, a "measure" is a law, regulation, rule, procedure, decision, administrative action, or any other form of measure. The only exception to this general rule is that the national treatment or most-favored nation treatment of the General Agreement on Tariffs and Trade will continue to apply with respect to trade in goods.

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

The proposed treaty contains a provision under which the saving clause (and therefore the U.S. jurisdiction to tax) applies to a former U.S. citizen or long-term resident whose loss of citizenship or resident status, respectively, had as one of its principal purposes the avoidance of tax; such application is limited to the ten-year period following the loss of citizenship or resident status. Section 877 of the Code provides special rules for the imposition of U.S. income tax on former U.S. citizens and long-term residents for a period of ten years following the loss of such citizenship or resident status; these special rules apply to a former citizen or long-term resident only if his or her loss of citizenship or resident status had as one of its principal purposes the avoidance of U.S. income, estate, or gift taxes. For purposes of applying the special tax rules to former citizens and long-term residents, individuals who meet a specified income tax liability threshold or a specified net worth threshold generally are considered to have lost citizenship or resident status for a principal purpose of U.S. tax avoidance.

Exceptions to the saving clause are provided for the following benefits conferred by the proposed treaty: correlative adjustments to the income of enterprises associated with other enterprises the profits of which were adjusted by South Africa (Article 9, paragraph 2); exemption from U.S. tax on social security benefits paid by South Africa, alimony and child support payments made by a resident of South Africa, and cross-border contributions to a South African pension fund (Article 18, paragraphs 2, 4, 5, 6 and 7); relief from double taxation (Article 23); nondiscrimination (Article 24); and mutual agreement procedures (Article 25).

In addition, the saving clause does not apply to certain benefits conferred by the United States with respect to an individual who neither is a U.S. citizen nor has been admitted as a U.S. permanent resident. Under this rule, the specified treaty benefits are available to a South African citizen who spends enough time in the United States to be taxed as a U.S. resident under Code section 7701(b) (see discussion below in connection with Article 4 (Residence)), provided that the individual has not acquired U.S. immigrant status (i.e., is not a green-card holder). The benefits that are subject to this rule are exemptions from U.S. tax for the following items of income: compensation and pensions for government service (Article 19); certain income received by temporary visitors who are students, apprentices or business trainees (Article 20); and certain fiscal privileges of diplomatic agents and consular officers referred to in the proposed treaty (Article 27).

The exceptions to the saving clause in the proposed treaty generally are consistent with the U.S. model and recent U.S. treaties.

Article 2. Taxes Covered

The proposed treaty generally applies to the income taxes of the United States and similar taxes of South Africa. However, for purposes of the non-discrimination article (Article 24), the proposed treaty applies to taxes of all kinds imposed by the countries, including any taxes imposed by their political subdivisions or local authorities. Moreover, Article 26 (Exchange of Information and Administrative Assistance) generally is applicable to all national-level taxes, including, for example, estate and gift taxes.

In the case of the United States, the proposed treaty applies to the Federal income taxes imposed by the Code, but excludes social security taxes. Unlike many U.S. income tax treaties in force, but like the U.S. model, the proposed treaty applies to the accumulated earnings tax and the personal holding company tax. In addition, the proposed treaty applies to the U.S. excise tax imposed with respect to private foundations.

In the case of South Africa, the proposed treaty applies to the normal tax and the secondary tax on companies.

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

Article 3. General Definitions

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

The term “South Africa” means the Republic of South Africa. When used in a geographical sense, the term “South Africa” includes the territorial sea of South Africa as well as any area outside the territorial sea over which South Africa exercises sovereign rights or jurisdiction, in accordance with international and South African laws, with regard to the exploration or exploitation of natural resources.

The term “United States” means the United States of America. The Technical Explanation states that it is understood that the term does not include Puerto Rico, the Virgin Islands, Guam, or any other U.S. possession or territory. When used in the geographic sense, the term “United States” means the States, the District of Columbia, and the territorial sea of the United States; it also includes the seabed and subsoil of underseas areas adjacent to the territorial sea over which the United States has sovereign rights in accordance with international law, for the purpose of exploration and exploitation of natural resources, but only to the extent that the person, property or activity to which the proposed treaty is being applied is connected with such exploration or exploitation.

The term “person” includes an individual, an estate, a trust, a partnership, a company, and any other body of persons. A “company” is any body corporate or any entity which is treated as a body corporate for tax purposes according to the laws of the country in which the entity is organized.

The terms “enterprise of a Contracting State” and “enterprise of the other Contracting State” are defined, respectively, as an enterprise carried on by a resident of a country, and an enterprise carried on by a resident of the other country. The proposed treaty does not define the term “enterprise.” The Technical Explanation states that the term “enterprise” generally is understood to refer to any activity or set of activities that constitute a trade or business.

Under the proposed treaty, a person is considered a “national” of one of the treaty countries if the person is an individual who is a citizen of that country or a legal person, partnership, association or other entity deriving its status as such from the laws in force in that country.

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

The proposed treaty also contains the standard provision that, unless the context otherwise requires or the competent authorities of the two countries agree to a common meaning, all terms not defined in the proposed treaty are to have the meanings which they have under the laws of the country concerning the taxes to which the proposed treaty applies. For these purposes, the proposed treaty provides that the meaning of a term under the applicable tax laws of that country will prevail over any meaning given to the term under non-tax laws of that country.

Article 4. Residence

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

Under U.S. law, residence of an individual is important because a resident alien is taxed on worldwide income, while a nonresident alien is taxed only on certain U.S.-source income and on income that is effectively connected with a U.S. trade or business. An individual who spends substantial time in the United States in any year or over a three-year period generally is treated as a U.S. resident (Code sec. 7701(b)). A permanent resident for immigration purposes (i.e., a green-card holder) also is treated as a U.S. resident. The standards for determining residence provided in the Code do not alone determine the residence of a U.S. citizen for the purpose of any U.S. tax treaty (such as a treaty that benefits residents, rather than citizens, of the United States). Under the Code, a company is domestic, and therefore taxable on its worldwide income, if it is organized in the United States or under the laws of the United States, a State, or the District of Columbia.

Under the proposed treaty, the term "resident of a Contracting State" is defined separately for U.S. residents and South African residents. The definition of a U.S. resident is consistent with that contained in the U.S. model. The Technical Explanation states that the definition of a South African resident is intended to include only those persons over which South Africa exerts its broadest taxing jurisdiction.

In the case of the United States, the proposed treaty defines the term "resident of a Contracting State" to mean any person who, under U.S. law, is liable to tax therein by reason of his or her domicile, residence, citizenship, place of incorporation, or any other criterion of a similar nature. The Technical Explanation states that the term also includes aliens who are considered U.S. residents under Code section 7701(b). The term does not include any person who is liable to tax in the U.S. in respect only of income from U.S. sources or of profits attributable to a permanent establishment in the United States. The term also includes a legal person organized under the laws of the United States that is generally exempt from U.S. tax and is established and maintained in the United States either (1) exclusively for a religious, charitable, educational, scientific, or other similar purpose, or (2) to provide pensions or other similar benefits to employees pursuant to a plan. The Technical Explanation states that the reference to an entity that is "generally" exempt from U.S. tax is intended to reflect the fact that under U.S. law, certain entities that generally are considered to be exempt from U.S. tax may be subject to certain excise taxes or to the income tax on unrelated business profits. The Technical Explanation also states that the term "other similar benefits" is intended to include employee benefits such as health and disability benefits.

In the case of South Africa, the proposed treaty defines the term "resident of a Contracting State" to mean any individual who is ordinarily resident in South Africa, and any legal person which is incorporated or has its place of effective management in South Africa.

The proposed treaty also defines "resident of a Contracting State" to include the United States or South Africa, or any of its political subdivisions or local authorities.

In the case of income, profit or gain derived through an entity that is fiscally transparent under the laws of either country, the proposed treaty provides that the income is considered to be derived by a resident of a country to the extent that the income is treated for purposes of the tax laws of such country as the income, profit or gain of a resident. The Technical Explanation states that fiscally transparent entities include entities such as partnerships and certain estates and trusts. In the case of the United States, such entities include partnerships, common investment trusts under section 584 of the Code, grantor trusts, and U.S. limited liability companies treated as partnerships for U.S. tax purposes. Thus, for example, if the U.S. partners' share in the income of a U.S. limited liability company (treated as a partnership for U.S. tax purposes) is only one-half, South Africa would be required to reduce its withholding tax pursuant to the proposed treaty on only one-half of the South African-source income paid to the partnership.

The Technical Explanation states that the rules in the proposed treaty for income derived through fiscally transparent entities apply regardless of where the entity is organized (i.e., in the United States, South Africa or a third country). The Technical Explanation also states that these rules apply even if the entity is viewed differently under the tax laws of the other country. As an example, the Technical Explanation states that income from South African sources received by an entity organized under the laws of South Africa, which is treated for U.S. tax purposes as a corporation and is owned by a U.S. shareholder who is a U.S. resident for U.S. tax purposes, is not considered derived by the shareholder of that corporation, even if under the tax laws of South Africa, the entity is treated as fiscally transparent. Rather, for purposes of the proposed treaty, the income is treated as derived by the South African entity.

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

In the case of a company that is resident in both countries under the basic residence rules, the proposed treaty provides that the company is treated as a resident of the country in which it is incorporated.

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

Article 5. Permanent Establishment

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

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

In general, under the proposed treaty, a permanent establishment is a fixed place of business through which the business of an enterprise is carried on in whole or in part. A permanent establishment includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or other place of extraction of natural resources. It also includes a warehouse, in relation to a person providing storage facilities for others, and a store or premises used as a sales outlet. The term also includes a ship, drilling rig, installation or other structure used for the exploration or exploitation of natural resources, but only if it lasts for more than 12 months. The term also includes a building site or construction, installation or assembly project, or supervisory activities in connection with such site or project, where such site, project or activities last for more than 12 months. Unlike the U.S. and OECD models, the term also includes the furnishing of services, including consultancy services, within a country by an enterprise through employees or other personnel engaged by the enterprise for such purposes, but only if such activities continue (for the same or a connected project) in that country for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the taxable year concerned. The Technical Explanation states that projects that are commercially and geographically interdependent are to be treated as a single project for purposes of the 12-month test. This rule providing the 12-month period for establishing a permanent establishment in connection with a site or project is similar to the rules of the U.S. and OECD models.

The general definition of a permanent establishment is modified to provide that a fixed place of business that is used for any of a number of specified activities does not constitute a permanent establishment. These activities include the use of facilities solely for storing, displaying, or delivering goods or merchandise belonging to the enterprise and the maintenance of a stock of goods or merchandise belonging to the enterprise solely for storage, display, or delivery or solely for processing by another enterprise. These activities also include the maintenance of a fixed place of business solely for the purchase of goods or merchandise or the collection of information for the enterprise. These activities include as well the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character. The Technical Explanation states that advertising and the supply of information qualify as activities that are preparatory or auxiliary. The proposed treaty, like the U.S. model, provides that the maintenance of a fixed place of business solely for any combination of these activities does not constitute a permanent establishment.

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

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

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

Article 6. Income from Immovable Property (Real Property)

This article covers income, but not gains, from real property. The rules covering gains from the sale of real property are contained in Article 13 (Capital Gains).

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

The term "immovable property (real property)" has the meaning which it has under the law of the country in which the property in question is situated.[6] The proposed treaty specifies that the term in any case includes property accessory to immovable property; livestock and equipment used in agriculture or forestry; rights to which the provisions of general law respecting landed property apply; usufruct of immovable property; and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. Ships, boats and aircraft are not considered to be real property.

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

Article 7. Business Profits

Internal taxation rules

United States

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

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

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

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

account; and certain sales income attributable to a U.S. sales office. Special rules apply in the case of insurance companies.

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

South Africa

Foreign corporations and nonresident individuals generally are subject to the South African normal tax only on income derived from sources within, or deemed to be within, South Africa. Business income derived in South Africa by a foreign corporation or nonresident individual generally is taxed in the same manner as the income of a domestic company or resident individual.

Proposed treaty limitations on internal law

Under the proposed treaty, profits of an enterprise of one country are taxable in the other country only to the extent that they are attributable to a permanent establishment in the other country through which the enterprise carries on business. This is one of the basic limitations on a country's right to tax income of a resident of the other country. As described above, unlike the U.S. and OECD models, the proposed treaty defines a permanent establishment of a country to include cases in which employees or other personnel of an enterprise provide services in that country for more than 183 days within a 12-month period in connection with the same or connected project. Thus, the rules of the proposed treaty granting the source country the right to tax business profits are somewhat broader than the corresponding rules in the U.S. and OECD models.

The taxation of business profits under the proposed treaty differs from U.S. rules for taxing business profits primarily by requiring more than merely being engaged in a trade or business before a country can tax business profits and by substituting an "attributable to" standard for the Code's "effectively connected" standard. Under the Code, all that is necessary for effectively connected business profits to be taxed is that a trade or business be carried on in the United States. Under the proposed treaty, a permanent establishment would have to be present and the business profits generally would have to be attributable to that permanent establishment.

The Technical Explanation states that it is understood that the business profits attributed to a permanent establishment include only those profits derived from that permanent establishment's assets or activities. This is consistent with the U.S. and OECD models and other existing U.S. treaties.

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

In computing taxable business profits, the proposed treaty provides that deductions are allowed for expenses incurred for the purposes of the permanent establishment. These deductions include a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole (or, if not the enterprise as a whole, at least the part of the enterprise that includes the permanent establishment), whether incurred in the country in which the permanent establishment is located or elsewhere. According to the Technical Explanation, under this language, the United States is free to use its current expense allocation rules, including the rules under Treas. Reg. secs. 1.861-8 and 1.882-5.

The proposed treaty specifies that in computing taxable business profits, no deductions are allowed for certain amounts incurred by the permanent establishment to any office of the enterprise, other than reimbursements of actual expenses. Such amounts include royalties, fees or similar payments in return for the use of patents or other rights; commissions or other charges for specific services performed or for management; or interest on moneys lent to the permanent establishment. As an example, the Technical Explanation states that a permanent establishment may not deduct a royalty deemed paid to the head office. It may, however, deduct an actual reimbursement to its head office for costs it incurred in developing an intangible generating the royalty. Similarly, the proposed treaty specifies that in computing taxable business profits, a permanent establishment may not take into account certain amounts charged by the permanent establishment to any office of the enterprise, other than for reimbursement of actual expenses. Such amounts include royalties, fees or similar payments in return for the use of patents or other rights; commissions or other charges for specific services performed or for management; or interest on moneys lent by the permanent establishment to any office of the enterprise.

Business profits are not attributed to a permanent establishment merely by reason of the purchase of merchandise by a permanent establishment for the enterprise. Thus, where a permanent establishment purchases goods for its head office, the business profits attributed to the permanent establishment with respect to its other activities are not increased by the profit element with respect to its purchasing activities.

The amount of profits attributable to a permanent establishment must be determined by the same method each year unless there is good reason to change the method. Where business profits include items of income which are dealt with separately in other articles of the proposed treaty, those other articles, and not the business profits article, govern the treatment of such items of income. Thus, for example, profits attributable to a U.S. ticket office of a South African airline are generally exempt from U.S. Federal income tax under the provisions of Article 8 (Shipping and Air Transport).

Unlike the U.S. model, the proposed treaty contains no definition of "business profits." The Technical Explanation states that the term "business profits" generally is understood to mean income derived from any trade or business, including income derived by an enterprise from the performance of personal services, and income from the rental of tangible personal property. This definition is the same as that contained in the U.S. model.

The proposed treaty incorporates the rule of Code section 864(c)(6) and provides that any income or gain attributable to a permanent establishment or a fixed base during its existence is taxable in the country where the permanent establishment or fixed base is located even though payments are deferred until after the permanent establishment or fixed base has ceased to exist. This rule applies with respect to business profits (Article 7, paragraphs 1 and 2), dividends (Article 10, paragraphs 4 and 6), interest (Article 11, paragraph 3), royalties (Article 12, paragraph 3), capital gains (Article 13, paragraph 3), independent personal services income (Article 14) and other income (Article 21, paragraph 2).

Article 8. Shipping and Air Transport

Article 8 of the proposed treaty covers income from the operation of ships and aircraft in international traffic. The rules governing income from the sale of ships and aircraft operated in international traffic are contained in Article 13 (Capital Gains).

Under the Code, the United States generally taxes the U.S.-source income of a foreign person from the operation of ships or aircraft to or from the United States. An exemption from U.S. tax is provided if the income is earned by a corporation that is organized in, or an alien individual who is resident in, a foreign country that grants an equivalent exemption to U.S. corporations and residents.

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

The proposed treaty provides that shipping profits include income from the rental of ships or aircraft if such ships or aircraft are operated in international traffic by the lessee, or if the rental income is incidental to profits from the operation of ships or aircraft in international traffic. The Technical Explanation states that income from the rental of ships or aircraft on a full basis (i.e., with crew) is considered to be income from the operation of ships and aircraft (and, thus, is covered under the general rule). This treatment is similar to the U.S. model.

The Technical Explanation states that, although not specified in the proposed treaty, profits derived by an enterprise from the inland transport of property or passengers within a country are treated as shipping profits eligible for exemption if such transport is undertaken as part of international traffic by the enterprise. This treatment is similar to the U.S. model.

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

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

Article 9. Associated Enterprises

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

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

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

When a redetermination of tax liability has been properly made by one country, the other country will make an appropriate adjustment to the amount of tax charged in that country on the redetermined income, if it agrees with the adjustment. In making that adjustment, due regard is to be given to other provisions of the proposed treaty, and the competent authorities of the two countries will consult with each other if necessary. For example, under the mutual agreement article (Article 25), a correlative adjustment cannot necessarily be denied on the ground that the time period set by internal law for claiming a refund has expired. To avoid double taxation, the proposed treaty's saving clause retaining full U.S. taxing jurisdiction with respect to its citizens and residents (discussed above in connection with Article 1 (General Scope)) does not apply in the case of such adjustments.

Article 10. Dividends

Internal taxation rules

United States

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

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

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

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

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

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

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

A foreign corporation engaged in the conduct of a trade or business in the United States is subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the accumulated U.S. effectively connected earnings of the corporation that are removed in any year from its U.S. trade or business. The dividend equivalent amount is limited by (among other things) aggregate earnings and profits accumulated in taxable years beginning after December 31, 1986. The Code provides that no U.S. treaty will exempt any foreign corporation from the branch profits tax (or reduce the amount thereof) unless the foreign corporation is a "qualified resident" of the treaty country. The definition of a "qualified resident" under U.S. internal law is somewhat similar to the definition of a corporation eligible for benefits under the proposed treaty (discussed below in connection with Article 22 (Limitation on Benefits)).

South Africa

Dividends received by resident or nonresident individuals or companies, whether from South African or foreign companies, generally are exempt from the South African normal tax. Dividends declared by a South African company are subject to a 12.5 percent secondary tax on companies ("STC"). Dividends received by the corporation can be offset against the dividends declared in computing the STC.

Dividends paid to nonresident individuals and foreign corporations by South African companies generally are not subject to a withholding tax.

A corporation with a branch in South Africa but whose place of effective management is outside South Africa is taxed on profits derived in South Africa. Such profits generally are subject to tax at a rate equal to the normal corporate tax rate plus five percentage points. Such a corporation is, however, exempt from the payment of the STC.

Proposed treaty limitations on internal law

Reduction of withholding tax

Under the proposed treaty, dividends paid by a company that is a resident of a country to a resident of the other country may be taxed in such other country. Dividends may also be taxed by the country in which the payor is resident, but the rate of tax is limited if the beneficial owner of the dividends is a resident of the other country. Under the proposed treaty, source-country taxation (i.e., taxation by the country in which the payor is resident) is limited to 5 percent of the gross amount of the dividends if the beneficial owner of the dividend is a company which holds directly at least 10 percent of the voting stock of the payor company. The source-country dividend withholding tax generally is limited to 15 percent of the gross amount of the dividend in all other cases. The Technical Explanation states that the "beneficial owner" of a dividend is understood generally to refer to any person resident in a country to whom that country attributes the dividend for purposes of its tax.

The proposed treaty provides that the 15-percent maximum tax rate applies to dividends paid by a RIC. The proposed treaty provides that the 15-percent maximum tax rate applies to dividends paid by a REIT to an individual owning less than 10 percent of the REIT. There is no limitation in the proposed treaty on the tax that may be imposed by the United States on a REIT dividend that is beneficially owned by a South African resident, if the beneficial owner of the dividend is either an individual holding a 10 percent or greater interest in the REIT or is not an individual. Thus, such a dividend is taxable at the 30-percent United States statutory rate.

Definition of dividends

The proposed treaty generally defines "dividends" as income from shares and other rights, not being debt-claims, which participate in profits. The term also includes income that is subjected to the same tax treatment as income from shares under the laws of the country in which the payor is resident. This rule is the same as the U.S. model. The Technical Explanation states that a distribution by a limited liability company is not treated by the United States as a dividend and, thus, is not a dividend for purposes of Article 10 (Dividends), provided that the limited liability company is not characterized as an association taxable as a corporation under U.S. law.

Special rules and exceptions

The proposed treaty's reduced rates of tax on dividends do not apply if the beneficial owner of the dividend carries on business through a permanent establishment (or a fixed base, in the case of an individual who performs independent personal services) in the source country and the dividends are attributable to the permanent establishment (or fixed base). Such dividends are taxed as business profits (Article 7) or as income from the performance of independent personal services (Article 14). In addition, dividends attributable to a permanent establishment or fixed base, but received after the permanent establishment or fixed base is no longer in existence are taxable in the country where the permanent establishment or fixed base existed (Article 7, paragraph 7).

The proposed treaty exempts from source-country tax dividends in cases in which the beneficial owner is (1) the United States or South Africa, or any of its political subdivisions or local authorities, or (2) a governmental pension trust or fund that is constituted and operated exclusively to administer government pension benefits, and that does not control the payor of the dividend.

The proposed treaty contains a general limitation on the taxation by a treaty country of dividends paid to a resident of the other country by a corporation that is not a resident of the first country (a so-called "second-level withholding tax"). Under this provision, a treaty country may not impose any tax on dividends paid by a corporation that is resident in the other country except where the dividends are paid to a resident of the first country, or insofar as the dividends are attributable to a permanent establishment or fixed base located in the other country, even if the dividends paid consist wholly or partly of profits or income arising in such country.

Branch profits tax

The proposed treaty permits the imposition of a branch profits tax on a company that is resident in a country and that either has a permanent establishment in the other country or, in the case of the United States, is subject to tax in the United States on a net basis on income from real property or gains from the disposition of real property interests. In cases where a South African company conducts a trade or business in the United States, but not through a permanent establishment, the proposed treaty would generally eliminate the U.S. branch profits tax otherwise imposed on such corporation.

In the case of South Africa, the proposed treaty specifies that the branch profits tax would be imposed at a rate that does not exceed the normal tax on companies by more than 5 percentage points. The Technical Explanation states that this tax is imposed in lieu of, and not in addition to, the normal tax on companies and the STC.

In the case of the United States, the proposed treaty specifies that the branch profits tax may not exceed 5 percent of the portion of profits of the corporation subject to tax in the United States that represents the dividend equivalent amount of such profits. The proposed treaty provides that the term "dividend equivalent amount" refers to the portion of the business profits of a permanent establishment subject to tax under Article 7 (Business Profits), or the portion of income from real property or gains from U.S. real property interests that is subject to tax in the United States on a net basis, that is comparable to the amount that would be distributed as a dividend if such income were earned by a locally incorporated subsidiary. The proposed treaty provides that the term "dividend equivalent amount" has the same meaning it has under U.S. law at it may be amended from time to time without changing the general principles of this article of the proposed treaty.

None of the restrictions on the operation of the U.S. branch tax provisions apply, however, unless the corporation seeking treaty protection meets the conditions of the proposed treaty's limitation on benefits article (Article 22). As discussed below, the limitation on benefits requirements of the proposed treaty are similar in some respects to the analogous provisions of the branch profits tax provisions of the Code.

Article 11. Interest

Internal taxation rules

United States

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

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

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

South Africa

South Africa generally does not impose a withholding tax on South African-source interest paid to nonresident individuals or foreign corporations. In certain cases, South African-source interest paid to nonresident individuals or foreign corporations may be subject to the normal tax.

Proposed treaty limitations on internal law

Elimination of withholding tax

The proposed treaty provides that interest derived and beneficially owned by a resident of a country is taxable only in that country. Thus, the proposed treaty generally exempts U.S.-source interest paid to South African residents from the 30-percent U.S. tax. This exemption from source-country taxation is consistent with the U.S. model. This exemption does not apply if the recipient of the interest is a nominee for a nonresident.

The exemption does not apply if the beneficial owner of the interest carries on business through a permanent establishment (or a fixed base, in the case of an individual who performs independent personal services) in the source country and the interest paid is attributable to the permanent establishment (or fixed base). In that event, the interest is taxed as business profits (Article 7) or income from the performance of independent personal services (Article 14). In addition, interest attributable to a permanent establishment or fixed base, but received after the permanent establishment or fixed base is no longer in existence, is taxable in the country where the permanent establishment or fixed base existed (Article 7, paragraph 7).

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

Under the proposed treaty, no exemption from source-country tax applies to an excess inclusion with respect to a residual interest in a REMIC. Thus, such inclusions may be taxed by the United States at a rate of 30 percent under the proposed treaty. In addition, the proposed treaty allows the source country to impose a tax, at a rate not exceeding 15 percent, on contingent interest that does not qualify as portfolio interest under U.S. law.

Definition of interest

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

Article 12. Royalties

Internal taxation rules

Under the same system that applies to dividends and interest, the United States imposes a 30-percent tax on U.S.-source royalties paid to foreign persons and on gains from the disposition of certain intangible property to the extent that such gains are from payments contingent on the productivity, use, or disposition of the intangible property. Royalties are from U.S. sources if they are for the use of property located in the United States. U.S.-source royalties include royalties for the use of, or the right to use, intangible property in the United States.

South Africa generally imposes a withholding tax of 12 percent on South African-source royalties paid to nonresident individuals and foreign corporations.

Proposed treaty limitations on internal law

The proposed treaty provides that royalties derived and beneficially owned by a resident of a country are taxable only in that country. Thus, the proposed treaty generally exempts U.S.-source royalties paid to South African residents from the 30-percent U.S. tax. This exemption from source-country taxation is similar to that provided in the U.S. model. The exemption does not apply if the recipient of the royalty is a nominee for a nonresident.

The exemption under the proposed treaty does not apply where the beneficial owner carries on business through a permanent establishment (or a fixed base, in the case of an individual who performs independent personal services) in the source country and the royalties are attributable to the permanent establishment (or fixed base). In that event, such royalties are taxed as business profits (Article 7) or income from the performance of independent personal services (Article 14). In addition, royalties attributable to a permanent establishment or fixed base, but received after the permanent establishment or fixed base is no longer in existence, are taxable in the country where the permanent establishment or fixed base existed (Article 7, paragraph 7).

Similar to the U.S. model and the OECD model, the proposed treaty defines "royalties" as any consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work (including computer software, cinematographic films, and audio or video tapes or disks and other means of image or sound reproduction); for the use of, or the right to use, any patent, trademark, design or model, plan, secret formula or process, or other like right or property; or for information concerning industrial, commercial or scientific experience. The term "royalties" also includes gains from the alienation of any property described above which are contingent on the productivity, use, or disposition of the property. The Technical Explanation states that the term "royalties" does not include income from leasing personal property.

The Technical Explanation states that income from the rental or licensing of computer programs may be treated as royalties or as income from the alienation of tangible personal property, depending on the facts and circumstances. The Technical Explanation states that a typical retail sale of a "shrink wrap" computer program generally will not be considered to give rise to royalty income.

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

Article 13. Capital Gains

Internal taxation rules

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

South Africa does not impose a tax on capital gains derived by resident or nonresident individuals or companies.

Proposed treaty limitations on internal law

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

Real property

Under the proposed treaty, gains derived by a treaty country resident from the disposition of real property situated in the other country may be taxed in the other country. For purposes of this article, real property situated in the other country includes (1) real property referred to in Article 6 (Income from Immovable Property (Real Property)), (2) a U.S. real property interest, or (3) an equivalent interest in real property located in South Africa. The Technical Explanation clarifies that distributions by a REIT that are attributable to gains derived from a disposition of real property are taxable under this article (and such gains are not taxable under the dividends article (Article 10)).

Other capital gains

Gains from the alienation of movable property that forms a part of the business property of a permanent establishment which an enterprise of one country has in the other country, gains from the alienation of movable property pertaining to a fixed base which is available to a resident of one country in the other country for the purpose of performing independent personal services, and gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or such a fixed base, may be taxed in that other country. Under the proposed treaty, such gains attributable to a permanent establishment or fixed base, but received after the permanent establishment or fixed base is no longer in existence, are taxable in the country where the permanent establishment or fixed base existed (Article 7, paragraph 7).

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

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

Article 14. Independent Personal Services

U.S. internal law

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

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

Proposed treaty limitations on internal law

Under the proposed treaty, income in respect of professional services or other activities of an independent character performed in one country by a resident of the other country is exempt from tax in the country where the services are performed (the source country) unless the individual performing the services crosses either of two thresholds in the source country.[7] The individual may be taxed in the source country if he or she has a fixed base regularly available to him or her in that country for the purpose of performing the services.[8] In that case, the source country is permitted to tax only that portion of the individual's income which is attrib-

[7] The Technical Explanation states that the term "professional services or other activities of an independent character" includes independent scientific, literary, artistic, educational, or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists, and accountants.

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

utable to the fixed base. In addition, if the individual is present in the source country for the purpose of performing the services for a period or periods exceeding 183 days within a twelve-month period, the individual is deemed to have a fixed base regularly available to him or her in the source country and the income derived from such activities performed in the source country is deemed to be attributable to that fixed base. In such latter case, the source country is permitted to tax the income derived from the performance of such services in the source country during that period. This latter rule represents a departure from the U.S. model, which would permit the source country to tax the income from independent personal services of a resident of the other country only if the income is attributable to a fixed base regularly available to the individual in the source country for the purpose of performing the activities.

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

Article 15. Dependent Personal Services

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

The proposed treaty also provides that remuneration derived by a resident of one country in respect of employment as a member of the complement of a ship or aircraft operated in international traffic is taxed only in that country. The Technical Explanation states that the "complement" of a ship or aircraft includes the crew.

This article is subject to the separate articles covering directors' fees (Article 16), pensions and annuities (Article 18), and government service income (Article 19).

Article 16. Directors' Fees

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

Article 17. Entertainers and Sportsmen

Similar to the U.S. and OECD models, the proposed treaty contains rules that apply to the taxation of income earned by entertainers (such as theater, motion picture, radio, or television "artistes," or musicians) and sportsmen. These rules apply notwithstanding the other provisions dealing with the taxation of income from personal services (Articles 14 and 15) and business profits (Article 7), and are intended, in part, to prevent entertainers and sportsmen from using the treaty to avoid paying any tax on their income earned in one of the countries.

Under this article of the proposed treaty, income derived by an entertainer or sportsman who is a resident of one country from his or her personal activities as such in the other country may be taxed in the other country if the amount of the gross receipts derived by him or her from such activities (including reimbursed expenses) exceeds $7,500 or its equivalent in South African rand for the taxable year concerned. Under this rule, if a South African entertainer or sportsman maintains no fixed base in the United States and performs (as an independent contractor) for one day of a taxable year in the United States for gross receipts of $2,000, the United States could not tax that income. If, however, that entertainer's or sportsman's gross receipts were $30,000, the full $30,000 (less appropriate deductions) would be subject to U.S. tax.

This provision does not bar the country of residence from also taxing that income (subject to a foreign tax credit). (See Article 23 (Elimination of Double Taxation), below.) The Technical Explanation states that because it is not possible to know whether the $7,500 (or the South African rand equivalent) threshold is exceeded until the end of the year, the source country may subject all payments to an entertainer or sportsman to withholding and refund any excess amount withheld.

According to the Technical Explanation, this article applies to all income connected with a performance by an entertainer or sportsman, such as appearance fees, award or prize money, and a share of the gate receipts. Income derived by an entertainer or sportsman from other than actual performance, such as royalties from record sales and payments for product endorsements, is not covered by this article; instead, these amounts are covered by other articles of the proposed treaty, such as Article 12 (Royalties) or Article 14 (Independent Personal Services). For example, if a South African entertainer receives royalty income from the sale of live recordings of a concert given in the United States, the royalty income will be exempt from U.S. withholding tax under Article 12 (Royalties), even if the remuneration from the concert itself may have been covered by this article.

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

The proposed treaty provides that income derived by entertainers or sportsmen resident in one country from activities performed in the other country will not be taxed by the source country if the visit of the entertainers or sportsmen is supported wholly or mainly from the public funds of the government of the residence country or of any of its political subdivisions or local authorities. This rule is not contained in the U.S. or OECD models.

The proposed treaty provides that the countries may, through the exchange of diplomatic notes, agree to increase the $7,500 threshold (or its South African rand equivalent) referred to above to reflect economic or monetary developments. Under the U.S. model, such changes in monetary thresholds can be accomplished by mutual agreement by the competent authorities, without requiring diplomatic notes to be exchanged between the countries.

Article 18. Pensions and Annuities

The proposed treaty specifies rules for the taxation of private (i.e., non-governmental service) pensions and annuities, social security benefits, alimony and child support payments, as well as for the tax treatment of contributions to, and earnings by, pension plans. Some of the rules are in certain respects different from the rules in the U.S. model.

Under the proposed treaty, pension distributions and other similar remuneration derived from sources within a country (the source country) and beneficially owned by a resident of the other country, whether paid periodically or as a single sum, may be taxed by the source country to a limited extent. This treatment is different from the U.S. model, which generally provides that pension distributions beneficially owned by a resident of a country are not taxable in the source country. The proposed treaty specifies that a pension or similar remuneration is deemed to arise from sources within a country to the extent that the service to which it relates is performed in that country. The Technical Explanation states that the term “pension distributions and other similar remuneration” is intended to cover payments made by private retirement plans and arrangements in consideration of past employment, as well as U.S. tier 2 railroad retirement benefits.

The proposed treaty specifies that in cases in which the United States is the source country, the tax imposed by the United States on pension distributions and similar remuneration beneficially owned by a resident of South Africa may not exceed 15 percent of the gross amount of such pension and remuneration, provided that such amount is not subject to a penalty for early withdrawal. The Technical Explanation states that if the distribution is subject to the early withdrawal penalty, the reduced rate under the proposed treaty will not apply and the rules under the Code will apply.

In cases in which South Africa is the source country, South Africa may tax pension distributions and similar remuneration beneficially owned by a U.S. resident, if the beneficial owner of such pension or remuneration: (1) has been employed in South Africa for a period or periods aggregating two years or more during the ten-year period immediately preceding the date from which the pension first became due, and (2) was employed in South Africa for a period or periods aggregating ten years or more. According to the Technical Explanation, a pension first becomes due for purposes of this rule on the first date on which the participant or beneficiary received a pension benefit, or if earlier, the first date such person could have received a payment if such person could have requested to have payment made at that earlier time. The Technical Explanation provides examples illustrating these rules.

Although not specified in the proposed treaty, the Technical Explanation states that if these conditions are satisfied, a pro rata amount of a pension distribution corresponding to the amount of the gross pension distribution from South African sources will be taxed to a beneficiary who is a U.S. resident. The Technical Explanation states that the portion of a pension distribution treated as South African-source income is equal to the total pension distribution multiplied by a fraction, the numerator of which is the employee's days of service for the employer in South Africa, and the denominator of which is the employee's total days of service for the employer.

These pension rules are subject to the provisions of Article 19 (Government Service). Thus, for example, the rules generally do not apply to pensions paid to a resident of one treaty country attributable to services performed for government entities of the other country.

The proposed treaty provides that social security payments and other similar public pensions paid by one country to a resident of the other country or to a U.S. citizen are taxable only in the paying country. This rule is similar to the rule in the U.S. model. The Technical Explanation states that it is understood that the term "other similar public pensions" is intended to refer to U.S. tier 1 railroad retirement benefits. This rule, which is not subject to the saving clause, exempts U.S. citizens and residents from U.S. tax on South African social security payments.

The proposed treaty provides that annuities beneficially derived by a resident of a country are taxable only in that country. However, if the annuity was purchased in the other country while such person was a resident of that other country, the annuity may also be taxed by that other country. This latter rule is not contained in the U.S. model. An annuity is defined as a stated sum paid periodically at stated times during life or a specified number of years, under an obligation to make the payments in return for adequate and full consideration (other than services rendered).

The proposed treaty provides that alimony paid by a resident of one country, and deductible in that country, to a resident of the other country, is taxable only in the payor's country of residence. However, if the alimony payment is not deductible in the payor's country of residence, the payment is exempt from tax in both countries. These rules are different from the U.S. model, which provides that alimony paid by a resident of a country, and deductible in that country, to a resident of the other country, is taxable only in the recipient's country of residence. For purposes of the proposed treaty, the term "alimony" means periodic payments made pursuant to a written separation agreement or a decree of divorce, separate maintenance or compulsory support.

The proposed treaty provides that child support payments made by a resident of a country to a resident of the other country, and which are not deductible in the payor's country of residence, are exempt from tax in both countries. According to the Technical Explanation, in the event that the payor is allowed a deduction for a child support payment in his or her country of residence, the payment would be taxable to the payee by the other country under Article 21 (Other Income). For these purposes, child support payments are periodic payments, not treated as alimony payments, for the support of a minor child made pursuant to a written separation agreement, or a decree of divorce, separate maintenance or compulsory support.

The proposed treaty provides special rules for individuals who are participants in a pension plan that is established and recognized under the legislation of one country (the plan country) and who perform personal services in the other country (the work country). These rules correspond to similar rules contained in the U.S. model. First, contributions paid by or on behalf of the individual to the plan during the period he or she performs such services in the work country are deductible (or excludible) in computing his or her taxable income in the work country. In addition, the proposed treaty provides that any benefits accrued under the plan or payments made to the plan by or on behalf of the individual's employer during that period are not treated as part of the employee's taxable income, and are allowed as a deduction in computing the employer's profits in the work country.

Second, the proposed treaty provides that income earned but not distributed by the plan is not taxable in the work country until such time and to the extent that the earnings are distributed from the plan. Thus, the proposed treaty permits deferral of tax on undistributed earnings realized by the plan.

Third, the proposed treaty provides that distributions from the plan to the individual are not subject to tax in the work country if the individual contributes such amounts to a similar plan established in the work country within a time period and in accordance with any other requirements imposed under the laws of the work country. Thus, the proposed treaty permits deferral of tax on rollovers of amounts from a pension plan in the plan country to a pension plan in the work country (subject to any restrictions on rollovers under the laws of the work country).

The proposed treaty provides that the individual can receive these benefits only if (1) contributions by or on behalf of the individual to the plan (or to another similar plan for which this plan was substituted) were made before he or she arrived in the work country, and (2) the competent authority of the work country has agreed that the pension plan generally corresponds to a pension plan recognized for tax purposes by the work country. The proposed treaty further specifies that these benefits are limited to the benefits that would be allowed by the work country to its residents for contributions to, or benefits otherwise accrued under, a pension plan recognized for tax purposes by the work country. As an example, the Technical Explanation states that if the work country has a cap on contributions to a plan equal to five percent of remuneration, and the plan country has a seven percent cap, a deduction by the individual for contributions to a plan is limited to five percent.

Article 19. Government Service

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

Any pension paid by, or out of funds created by, a country or one of its political subdivisions or local authorities, to an individual for services rendered to the payor country generally is taxable only in that country. However, such pensions are taxable only in the other country if the individual is both a resident and a national of that other country. The Technical Explanation states that the phrase "paid by, or out of funds created by" a country is intended to clarify that remuneration or pensions paid by entities such as government-owned corporations may also be covered by this article.

The proposed treaty provides that this article does not apply to payments in respect of services rendered in connection with any trade or business carried on by either country or any of its political subdivisions or local authorities. This treatment is similar to the U.S. model, which limits the application of the corresponding article in the U.S. model to services rendered "in the discharge of functions of a governmental nature." The Technical Explanation clarifies that remuneration excluded from this article because of this rule is subject to the provisions relating to personal services income (Articles 14 and 15), directors' fees (Article 16), income of entertainers and sportsmen (Article 17), and pensions and annuities (Article 18).

This article is an exception to the saving clause, pursuant to Article 1, paragraph 5(b) of the proposed treaty. Consequently, the saving clause does not apply to benefits conferred by this article to an individual who is neither a U.S. citizen nor a U.S. green-card holder. Thus, for example, the United States would not tax the compensation of a South African citizen who is not a U.S. green-card holder but who resides in the United States to perform services for the South African Government.

Article 20. Students, Apprentices and Business Trainees

Under the proposed treaty, a student, apprentice, or business trainee who visits the other country (the host country) for the purpose of full-time education or training, and who is, or immediately before that visit was, a resident of the other treaty country, generally is exempt from tax in the host country on payments that arise from sources outside the host country for the purposes of maintenance, education, or training. The Technical Explanation states that a payment is considered to arise from sources outside the host country if the payor is located outside the host country. In the case of an apprentice or trainee, this treaty benefit applies only for a period not exceeding one year from the date the individual first arrives in the host country for the purposes of his or her apprenticeship or training. In the case of a student, this treaty benefit applies regardless of the length of the stay. This treatment is similar to the U.S. model. The OECD model also provides some host-country exemptions for students and trainees; however, unlike the proposed treaty and the U.S. model, the OECD model does not contain a time limit on the exemption from host tax with respect to trainees.

This article is an exception to the saving clause, pursuant to Article 1, paragraph 5(b) of the proposed treaty. Consequently, the saving clause does not apply to benefits conferred by this article to an individual who is neither a U.S. citizen nor a U.S. green-card holder. Thus, for example, the United States would not tax remittances from abroad of a South African citizen who is not a U.S. green-card holder but who visits the United States as a full-time student.

Article 21. Other Income

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

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

The general rule just stated does not apply to income (other than income from immovable property (as defined in Article 6)) if the beneficial owner of the income is a resident of one country and carries on business in the other country through a permanent establishment or a fixed base to which the income is attributable. In such a case, the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, will apply. Thus, for example, income arising outside the United States that is attributable to a permanent establishment maintained in the

United States by a resident of South Africa generally would be taxable by the United States under Article 7 (Business Profits), even if the income was sourced in a third country.

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

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

Article 22. Limitation on Benefits

In general

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

Summary of proposed treaty provisions

The proposed anti-treaty-shopping article provides that a resident of a country is entitled to all treaty benefits in the other country only to the extent provided in this article. Under this provision, certain persons are identified as qualifying as residents of a country. Alternatively, certain items of income of a treaty resident may qualify for treaty benefits if the resident satisfies one of several other tests of the proposed treaty. This provision of the proposed treaty is in some ways comparable to the U.S. Treasury regulation under the branch tax definition of a qualified resident.[9] However, the proposed treaty provides opportunities for treaty benefit eligibility which are not provided for under the regulation.

The proposed treaty entitles a resident of either country to qualify for all the benefits accorded by the proposed treaty if such resident falls within one of the following categories:

(1) An individual;
(2) One of the treaty countries, a political subdivision or local authority thereof;
(3) A company that satisfies an ownership test and a base erosion test;
(4) A trust that satisfies an ownership test and a base erosion test;
(5) A company that satisfies a public company test;
(6) A company that is owned by certain public companies;
(7) A not-for-profit, tax-exempt organization; or
(8) A tax-exempt pension fund

Such persons will be referred to as "qualified residents." Alternatively, a resident that does not fit into any of the above categories may claim treaty benefits with respect to certain items of income under the active business test. Moreover, a treaty country resident is entitled to treaty benefits if the resident is otherwise approved by the source country's competent authority, in the exercise of the latter's discretion. Special rules apply to income derived by a resident of South Africa in certain "triangular" cases described below.

Ownership and base erosion tests—companies

Similar to many U.S. treaties that have a limitation on benefits article, the proposed treaty contains an ownership test and a base erosion payment test, both of which must be met if a company is to qualify for treaty benefits under this rule. The tests under the proposed treaty are similar, but not identical, to those contained in the U.S. model.

Ownership test

To meet the ownership test, at least 50 percent of each class of shares or other beneficial interests in the company must be owned, directly or indirectly, on at least half the days during the taxable year by: individual residents of South Africa or the United States; the countries themselves, political subdivisions or local authorities of the countries; certain publicly traded companies and companies owned by certain publicly traded companies (as described in the discussion of the public company tests below); or certain tax-exempt organizations including charitable organizations and pension funds (as described in the discussion of tax-exempt entities below). The proposed treaty provides that in the case of indirect ownership, each person in the chain of ownership must be entitled to the benefits of the proposed treaty as one of the qualified residents referred to above.

[9] Treas. Reg. sec. 1.884-5.

Base erosion test

The base erosion test is met only if less than 50 percent of the gross income of the company for the year is paid or accrued, directly or indirectly, to persons who are not residents of either country, in the form of payments that are deductible for income tax purposes in the company's country of residence. Under the proposed treaty, payments by the company to a resident of either country, or payments that are attributable to a permanent establishment in either country, are not considered base eroding payments for these purposes. This test is intended to prevent a corporation, for example, from distributing most of its income in the form of deductible payments such as interest, royalties, service fees, or other amounts to persons not entitled to benefits under the proposed treaty.

Ownership and base erosion tests—trusts

The proposed treaty provides a separate ownership test and base erosion test for trusts. These rules are similar to the ownership and base tests for companies described above; however, the proposed treaty provides more stringent ownership rules in the case of trusts. This is unlike the U.S. model, which generally applies the same ownership and base erosion tests to companies and trusts.

Ownership test

Under the proposed treaty, the ownership test is met if at least 80 percent of the aggregate beneficial interests in the trust is owned, directly or indirectly, on at least 274 days during the taxable year by: individual residents of South Africa or the United States; the countries themselves, political subdivisions or local authorities of the countries; certain publicly traded companies and companies owned by certain publicly traded companies (as described in the discussion of the public company tests below); certain tax-exempt organizations including charitable organizations and pension funds (as described in the discussion of tax-exempt entities below); or companies satisfying the ownership and base erosion tests. The at-least-80 percent ownership threshold for trusts is more stringent than the at-least-50 percent ownership threshold for companies, described above. The proposed treaty provides that in the case of indirect ownership, each person in the chain of ownership must be entitled to the benefits of the proposed treaty as one of the qualified residents referred to above.

Base erosion test

The base erosion test under the proposed treaty is the same as the base erosion test for companies described above. This test requires that less than 50 percent of the trust's gross income be paid or accrued, directly or indirectly, to nonresidents of either country (unless the income is attributable to a permanent establishment located in either country), in the form of payments that are deductible for tax purposes in the trust's country of residence. The Technical Explanation states that trust distributions would be considered deductible payments to the extent that they are deductible from the tax base.

Public company tests

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

Publicly traded companies

A company that is a resident of South Africa or the United States is entitled to treaty benefits if all the shares in the class or classes of its shares representing more than 50 percent of the voting power and value of the company are regularly traded on a recognized stock exchange. Thus, such a company is entitled to the benefits of the proposed treaty regardless of where its actual owners reside or the amount or destination of payments it makes. The Technical Explanation states that the requirement that "all the shares" in the principal class of shares be regularly traded makes clear that all shares in the principal class (or classes) of shares of the company must be regularly traded, as opposed to only a portion of such shares. This treatment is consistent with the U.S. model.

Although the term "regularly traded" is not defined in the proposed treaty, the Technical Explanation states that the term will be defined by reference to the domestic laws of the country in which treaty benefits are sought. The Technical Explanation states that in the case of the United States, this term is understood to have the meaning it has under Treasury regulations relating to the branch profits tax provisions of section 884 of the Code.

Subsidiaries of publicly traded companies

A company that is a resident of South Africa or the United States is entitled to treaty benefits if at least 50 percent of each class of shares in the company is owned, directly or indirectly, by companies that satisfy the public company tests described above. The proposed treaty provides that in the case of indirect ownership, each intermediate owner in the chain must be a person entitled to the benefits of the proposed treaty (as one of the qualified residents referred to above) under this article.

Other definitions

For purposes of this article, the term "recognized stock exchange" means the NASDAQ System owned by the National Association of Securities Dealers, Inc.; any stock exchange registered with the Securities and Exchange Commission as a national securities exchange under the Securities Exchange Act of 1934; the Johannesburg Stock Exchange; and any other exchange agreed upon by the competent authorities of the two countries.

Tax-exempt organizations

Charitable organizations

An entity also is entitled to benefits under the proposed treaty if it is a legal person organized under the laws of a country and is generally exempt from tax in that country under laws relating to charitable and other similar organizations. The Technical Explanation clarifies that such organizations include entities organized and operated exclusively to fulfill religious, educational, scientific and other charitable purposes. Like the U.S. model, and unlike some recent treaties, there is no requirement that specified percentages of the beneficiaries of these organizations be residents of one of the countries.

Pension funds

An entity also is entitled to the benefits under the proposed treaty if it is a legal person organized under the laws of a country, is generally exempt from tax in that country, and is established and maintained in that country to provide pensions or other similar benefits to employees pursuant to a plan; provided that more than 50 percent of the beneficiaries, members or participants are individuals resident in either country. This rule is similar to a rule contained in the U.S. model.

Active business test

In general

Under the active business test, treaty benefits in the source country are available under the proposed treaty to an entity that is a resident of the United States or South Africa if (1) it is engaged directly in the active conduct of a trade or business in its country of residence, (2) the income derived from the source country is derived in connection with, or is incidental to, that trade or business, and (3) the trade or business is substantial in relation to the activity of the resident (and any related parties) in the source country. These rules are generally similar to the rules in the U.S. model.

The proposed treaty provides that the business of making or managing investments is not considered to be an active trade or business for purposes of these rules, unless the activity is a banking, insurance or securities activity conducted by a bank, insurance company or registered securities dealer, respectively. The Technical Explanation states that a headquarters operation will not be considered to be engaged in an active trade or business for purposes of these rules.

Income derived in connection with, or incidental to, a trade or business

The proposed treaty specifies that an item of income is derived in connection with a trade or business if the income-producing activity in the source country is a line of business which forms a part of, or is complementary to, the trade or business conducted in the residence country.[10] This rule is similar to the rule in the U.S. model. The Technical Explanation states that it is intended that a business activity generally will be considered to "form a part of" a business activity conducted in the other country if the two activities involve the design, manufacture or sale of the same products or type of products, or the provision of similar services. The Technical Explanation further states that in order for activities to be "complementary," the activities need not relate to the same types of products or services, but they should be part of the same overall industry and be related in the sense that success or failure of one activity will tend to result in the success or failure of the other activity. The Technical Explanation provides several examples illustrating these principles.

The proposed treaty specifies that income is incidental to a trade or business if it facilitates the conduct of a trade or business in the other country. This rule is the same as the rule in the U.S. model.

Substantiality

The proposed treaty provides that whether a trade or business of a resident is substantial is determined based on all the facts and circumstances. According to the Technical Explanation, the factors to be considered include the relative scale of the activities conducted in the two countries, and the relative contributions made to the conduct of the trade or business in both countries.[11] However, the proposed treaty includes a safe harbor under which the trade or business of the resident is considered to be substantial if certain attributes of the residence-country business exceed a threshold fraction of the corresponding attributes of the trade or business located in the source country that produces the source-country income. Under this safe harbor, the attributes are assets, gross income, and payroll expense. To satisfy the safe harbor, the level of each such attribute in the active conduct of the trade or business by the resident (and any related parties) in the residence country, and the level of each such attribute in the trade or business producing the income in the source country, is measured for the prior year or for the prior three years. For each separate attribute, the ratio of the residence country level to the source country level is computed.

In general, the safe harbor is satisfied if, for the prior year or for the average of the three prior years, the average of the three ratios exceeds 10 percent, and each ratio separately is at least 7.5 percent. These rules are similar, but not identical, to those contained in the U.S. model. The Technical Explanation states that if a resident owns less than 100 percent of an activity in either country, the resident will only include its proportionate interest in such activity for purpose of computing the safe harbor percentages.

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

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

Grant of treaty benefits by the competent authority

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

The Technical Explanation provides that the competent authority of a country will base its determination on whether the establishment, acquisition, or maintenance of the person seeking benefits under the proposed treaty, or the conduct of such person's operations, has or had as one of its principal purposes the obtaining of benefits under the proposed treaty. Thus, persons that establish operations in either the United States or South Africa with the principal purposes of obtaining benefits under the proposed treaty ordinarily will be denied such benefits.

Triangular cases

Under present laws and treaties that apply to South African residents, it is possible for profits of a permanent establishment maintained by a South African resident in a third country to be subject to a very low aggregate rate of South African and third-country income tax. The proposed treaty, in turn, eliminates the U.S. tax on several specified types of income of a South African resident. In a case where the U.S. income is earned by a third-country permanent establishment of a South African resident (the so-called "triangular case") the proposed treaty could have the potential of helping South African residents to avoid all (or substantially all) taxation, rather than merely avoiding double taxation. The proposed treaty is drafted unilaterally to apply only to income of a South African resident, because it has no application with respect to the United States—the United States does not exempt profits of a U.S. person attributable to a foreign permanent establishment.

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

In order for the special rule to apply, four conditions must be satisfied. First, a South African enterprise must derive income from the United States. Second, such income must be attributable to a permanent establishment that the South African enterprise has in a third country. Third, the South African enterprise must be exempt from South African tax on the profits attributable to the third-country permanent establishment. Fourth, the combined South African and third-country taxation of the item of U.S.-source income earned by the South African enterprise and the third-country permanent establishment must be less than 50 percent of the South African tax that would be imposed if the income were earned by the same enterprise in South Africa and were not attributable to the permanent establishment.

The special rule does not apply to interest derived in connection with, or incidental to, the active conduct of a trade or business carried on by the permanent establishment in the third country (other than the business of making or managing investments unless these activities are banking or insurance activities carried on by a bank or insurance company, respectively). The special rule also does not apply to royalties received as compensation for the use of, or the right to use, intangible property produced or developed by the third-country permanent establishment. In addition, the special rule does not apply to income derived by a South African enterprise if the United States taxes the profits of that enterprise according to the subpart F controlled foreign corporation provisions of the Code (as it may be amended from time to time without changing the general principles thereof). [12]

Article 23. Elimination of Double Taxation

Internal taxation rules

United States

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

A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax on U.S.-source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit only offsets U.S. tax on foreign source income. The foreign tax credit limitation generally is computed on a worldwide consolidated basis. Hence, all income taxes paid to all foreign countries are combined to offset U.S. taxes on all foreign income. The limitation is computed separately for certain classifications of income (e.g., passive income and financial services income) in order to prevent the crediting of foreign taxes on certain high-taxed foreign source income against the U.S. tax on certain types of traditionally low-taxed foreign source income. Other limitations may apply in determining the amount of foreign taxes that may be credited against the U.S. tax liability of a U.S. taxpayer.

[12] Similar subpart F exceptions from this special rule also are found in other recent U.S. income tax treaties (e.g., the 1995 U.S.-France income tax treaty).

South Africa

In general, South African law allows resident individuals and domestic companies a credit for foreign taxes payable on income derived from non-South African sources if that income is also taxable by South Africa. The foreign tax credit cannot exceed the South African tax payable on the foreign income in question.

Proposed treaty rules

Overview

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

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

Proposed treaty limitations on U.S. internal law

The proposed treaty generally provides that the United States will allow a U.S. citizen or resident a foreign tax credit for South African tax paid or accrued by or on behalf of such citizen or resident. The proposed treaty also provides that the United States will allow a deemed-paid credit, with respect to South African tax, to any U.S. corporate shareholder of a South African company that receives dividends from such company if the U.S. company owns 10 percent or more of the voting stock of the South African company.

The credit generally is to be computed in accordance with the provisions and subject to the limitations of U.S. law (as those provisions and limitations may change from time to time without changing the general principles of the treaty provisions). This provision generally is similar to those found in the U.S. model and many U.S. income tax treaties.

The Technical Explanation states that South African taxes covered by the proposed treaty (Article 2 (Taxes Covered)) generally are considered income taxes for purposes of the U.S. foreign tax credit rules. According to the Technical Explanation, certain portions of South Africa's STC might, in a given case, not be creditable for U.S. tax purposes.

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

(1) Compute the tentative U.S. income tax and the tentative South African income tax with respect to items of income that, under the proposed treaty, are subject to South African tax and are either exempt from U.S. tax or are subject to a reduced

rate of tax when derived by a South African resident who is not a U.S. citizen.

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

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

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

Proposed treaty limitations on South African internal law

Under the proposed treaty, United States taxes paid by South African residents in accordance with the proposed treaty will be allowed as a deduction against the South African taxes due under South African tax law. U.S. taxes imposed solely by reason of citizenship under the saving clause (Article 1, paragraph 4) are not covered by this rule. The proposed treaty specifies that the amount of the South African reduction from tax may not exceed an amount which bears to the total South African tax payable (before such reduction) the same ratio as the income concerned bears to the total income taxable in South Africa.

Article 24. Non-discrimination

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

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

Under the proposed treaty, neither country may tax a permanent establishment or fixed base of an enterprise or resident of the other country less favorably than it taxes its own enterprise or resident carrying on the same activities. However, nothing in this article will be construed as preventing either country from imposing a branch profits tax (Article 10, paragraph 6). Consistent with the

U.S. and OECD models, a country is not obligated to grant residents of the other country any personal allowances, reliefs, or reductions for tax purposes on account of civil status or family responsibilities which it grants to its own residents.

Under the proposed treaty, each country is required (subject to the arm's-length pricing rules of Articles 9 (Associated Enterprises), 11 (Interest), and 12 (Royalties)) to allow its residents to deduct interest, royalties, and other disbursements paid by them to residents of the other country under the same conditions that it allows deductions for such amounts paid to residents of the same country as the payor. The Technical Explanation states that the term "other disbursements" is understood to include a reasonable allocation of executive and general administrative expenses, research and development expenses, and other expenses incurred for the benefit of a group of related enterprises.

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

U.S. internal law generally treats a corporation that distributes property in complete liquidation as realizing gain or loss as if the property had been sold to the distributee. If, however, 80 percent or more of the stock of the corporation is owned by another corporation, a nonrecognition rule applies and no gain or loss is recognized to the liquidating corporation. A special provision makes the nonrecognition provision inapplicable if the distributee is a foreign corporation (Code sec. 367(e)(2)). Even where the distributee is a foreign corporation resident in a treaty country, such treatment is not considered discriminatory, because absence of tax to the subsidiary in this case represents a complete elimination of U.S. tax jurisdiction over any appreciation, while a similar absence in the case of a domestic distributee simply shifts the appreciation into the hands of another U.S. taxpayer.[13] The Technical Explanation states that the application of Code section 367(e)(2) is consistent with the nondiscrimination article of the proposed treaty. The Technical Explanation states that a similar analysis applies to the treatment of section 355 distributions subject to section 367(e)(1).

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

[13] See Notice 87-66, 1987-2 C.B. 376.

shareholder of an S corporation, are not in conflict with the nondiscrimination provisions of the proposed treaty.

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

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

Article 25. Mutual Agreement Procedure

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

Under this article, a resident of one country, who considers that the action of one or both of the countries results, or will result, in him or her paying a tax not in accordance with the proposed treaty, may present the case to the competent authority of either country. This provision is similar to the U.S. model, which also permits a person to bring his or her case to the competent authority of either country. Like the OECD model, the proposed treaty specifies that the case must be presented within three years from the first notification of the action giving rise to taxation not in accordance with the provisions of the proposed treaty. In the case of taxes withheld at source, the case must be brought within three years of the date of collection of the tax.

The proposed treaty provides that a competent authority will make a determination as to whether the objection appears justified. If the objection appears to be justified and if the competent authority is not itself able to arrive at a satisfactory solution, then the competent authority will endeavor to resolve the case by mutual agreement with the competent authority of the other country, with a view to the avoidance of taxation which is not in accordance with the proposed treaty. The proposed treaty provides that any agreement is to be implemented even if such implementation would be barred by the statute of limitations or other procedural limitations, such as a closing agreement. The Technical Explanation states that in a case where a taxpayer has entered into a closing agreement or other written settlement with the United States prior to bringing a case to the competent authorities, the U.S. competent authority will endeavor only to obtain a correlative adjustment from

South Africa and will not take any action that would otherwise change such agreements.

The competent authorities of the countries are to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the proposed treaty. The competent authorities of the countries may also consult together for the elimination of double taxation in cases not provided for in the proposed treaty.

The proposed treaty authorizes the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of this mutual agreement article. This provision makes clear that it is not necessary to go through diplomatic channels in order to discuss problems arising in the application of the proposed treaty. It also removes any doubt as to restrictions that might otherwise arise by reason of the confidentiality rules of the United States or South Africa. The proposed treaty specifies that the competent authorities, through consultations, will develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedures provided for in this article. The proposed treaty permits a competent authority to devise appropriate unilateral procedures, conditions, methods, and techniques to facilitate the bilateral actions taken by the competent authorities and the implementation of the mutual agreement procedures.

The proposed treaty specifies that the competent authorities may agree on various issues including the attribution of income, deductions, credits, or allowances of a permanent establishment of an enterprise of a treaty country; the allocation of income, deductions, credits or allowances between persons; the characterization of particular items of income; the characterization of persons; the application of source rules with respect to particular items of income; and the common meaning of a term. The proposed treaty does not specify, as does the U.S. model, that the competent authorities may agree on advance pricing arrangements and the application of penalties, fines, and interest under internal law. However, the Technical Explanation states that the competent authorities may reach agreement on issues not enumerated in the proposed treaty if necessary to avoid double taxation.

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

Article 26. Exchange of Information and Administrative Assistance

Exchange of information

The proposed treaty provides for the exchange of information necessary to carry out the provisions of the proposed treaty or of the specified tax laws of the two countries provided that taxation under those domestic laws is not contrary to the proposed treaty. The Technical Explanation states that the reference to information "necessary" to carry out the provisions of the proposed treaty is understood to be equivalent to the reference in the U.S. model to information that is "relevant." Thus, a country requesting information should not be required to demonstrate that it would be disabled from enforcing its tax laws before it could obtain a particular item of information.

The exchange of information is not restricted by Article 1 (General Scope). Therefore, third-country residents are covered. Like the U.S. model, the proposed treaty permits information to be exchanged with respect to all taxes administered by the competent authorities of the countries. Thus, the taxes covered by the proposed treaty for purposes of the exchange of information article is broader than some other recent treaties, which limits the scope of the exchange of information provisions only to specified taxes covered under the treaty. The Committee understands that information to be exchanged under this article includes bank information. The proposed treaty explicitly excludes customs duties from the exchange of information provisions.

Any information received by a country is to be treated as secret in the same manner as information obtained under the domestic laws of the country receiving the information. The exchanged information may be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, administration, enforcement, prosecution or determination of appeals with respect to the taxes covered by the proposed treaty. The information exchanged may be used only for such purposes.[14] The Technical Explanation states that the appropriate committees of the U.S. Congress and the U.S. General Accounting Office will be afforded access to information for use in the performance of their role in overseeing the administration of U.S. tax laws. Exchanged information may be disclosed in public court proceedings or in judicial decisions.

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

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

The proposed treaty provides that the competent authority of a requested country will allow representatives of a requesting country to enter the requested country to interview individuals and ex-

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

amine books and records with the consent of the persons subject to the examination.

Assistance in collection

The proposed treaty provides for each of the countries to endeavor to collect taxes on behalf of the other country as may be necessary to ensure that treaty benefits do not inure to the benefits of persons not entitled to such benefits. Similar to the U.S. model, the collection provision does not impose on either treaty country the obligation to carry out administrative measures of a different nature from those used in the collection of its own taxes, or that would be contrary to its sovereignty, security, or public policy.

Article 27. Diplomatic Agents and Consular Officers

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

Article 28. Entry Into Force

The proposed treaty provides that the countries must notify each other that the constitutional requirements for the entry into force of the proposed treaty has been complied with. The Technical Explanation states that these constitutional requirements include ratification of the proposed treaty.

The proposed treaty will enter into force thirty days after the date on which the second of the two notifications of the completion of the constitutional requirements have been received. With respect to taxes payable at source, the proposed treaty will be effective for amounts paid or credited on or after the first day of January in the year following the date of entry into force. With respect to other taxes, the proposed treaty will be effective for taxable periods beginning on or after that first day of January.

Article 29. Termination

The proposed treaty will continue in force until terminated by a treaty country. Either country may terminate it through diplomatic channels by giving notice at least six months before the end of any calendar year starting five years after the year the treaty has entered into force. A similar termination rule is contained in many other U.S. tax treaties. With respect to taxes payable at source, a termination will be effective for amounts paid or credited on or after the first day of January following the year in which notice of termination is given. With respect to other taxes, a termination will be effective for taxable periods beginning on or after the first day of January following the year in which such notice of termination is given.

IX. Text of the Resolution of Ratification

Resolved, (two-thirds of the Senators present concurring therein), That the Senate advise and consent to the ratification of the Convention between the United States of America and the Republic of South Africa for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, signed at Cape Town February 17, 1997 (Treaty Doc. 105-9), subject to the declaration of subsection (a), and the proviso of subsection (b).

(a) DECLARATION.—The Senate's advice and consent is subject to the following declaration, which shall be binding on the President:

(1) TREATY INTERPRETATION.—The Senate affirms the applicability to all treaties of the constitutionally based principles of treaty interpretation set forth in Condition (1) of the resolution of ratification of the INF Treaty, approved by the Senate on May 27, 1988, and Condition (8) of the resolution of ratification of the Document Agreed Among the States Parties to the Treaty on Conventional Armed Forces in Europe, approved by the Senate on May 14, 1997.

(b) PROVISO.—The resolution of ratification is subject to the following proviso, which shall be binding on the President:

(1) SUPREMACY OF THE CONSTITUTION.—Nothing in the Treaty requires or authorizes legislation or other action by the United States of America that is prohibited by the Constitution of the United States as interpreted by the United States.

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