
TAXATION CONVENTION WITH AUSTRIA

OCTOBER 30, 1997.—Ordered to be printed

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

REPORT

[To accompany Treaty Doc. 104-31]

The Committee on Foreign Relations, to which was referred the Convention between the United States of America and the Republic of Austria for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Vienna on May 31, 1996, having considered the same, reports favorably thereon, with one understanding, two declarations, 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.

CONTENTS

	Page
I. Purpose	1
II. Background	2
III. Summary	2
IV. Entry Into Force and Termination	3
V. Committee Action	3
VI. Committee Comments	4
VII. Budget Impact	19
VIII. Explanation of Proposed Treaty	19
IX. Text of of the Resolution of Ratification	67

I. PURPOSE

The principal purposes of the proposed income tax treaty between the United States and Austria 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 continue 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.

II. BACKGROUND

The proposed treaty was signed on May 31, 1996. The United States and Austria also exchanged notes, with an attached Memorandum of Understanding (the "MOU"), on May 31, 1996. The proposed treaty would replace the existing income tax treaty between the two countries that was signed in 1956.

The proposed treaty was transmitted to the Senate for advice and consent to its ratification on September 4, 1996 (see Treaty Doc. 104-31). 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 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 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 22).

¹The 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.

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

The proposed treaty also contains a detailed limitation on benefits provision to prevent the inappropriate use of the proposed treaty (Article 16).

IV. ENTRY INTO FORCE AND TERMINATION

A. ENTRY INTO FORCE

The proposed treaty provides that the instruments of ratification are to be exchanged as soon as possible. The proposed treaty will enter into force on the first day of the second month following the exchange of instruments of ratification. The present treaty generally ceases to have effect once the provisions of the proposed treaty take effect.

In the case of taxes payable at source, the proposed treaty takes effect for payments made on or after the first day of the second month following the entry into force (i.e., the first day of the fourth month following the exchange of instruments of ratification). In the case of other taxes, the proposed treaty takes effect for taxable years and periods beginning on or after the first of January following the entry into force.

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

B. TERMINATION

The proposed treaty will continue in force until terminated by a treaty country. Either country may terminate it at any time after five years from the date of its entry into force by giving at least six months prior written notice through diplomatic channels. With respect to taxes payable at source, a termination will be effective for payments made after the end of the calendar year in which such notice has been given. With respect to other taxes, a termination will be effective for taxable years and periods beginning after the end of the calendar year in which the notice has been given.

V. COMMITTEE ACTION

The Committee on Foreign Relations held a public hearing on the proposed treaty with Austria (Treaty Doc. 104-31), 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 or-

dered the proposed treaty with Austria 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 an understanding, two declarations and a proviso.

VI. COMMITTEE COMMENTS

On balance, the Committee on Foreign Relations believes that the proposed treaty with Austria 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 such as the present treaty with Austria, 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

²The proposed treaty, like many treaties, allows the foreign person to elect to be taxed in the source country on income derived from real property on a net basis under the source country's domestic laws.

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.

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.

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

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

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

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

vides 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. In addition, the Treasury Department has committed to use its best efforts to negotiate a protocol with Austria to amend the proposed treaty to incorporate this policy.

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 encourages the Treasury Department to act expeditiously in meeting its commitment to negotiate a protocol with Austria that incorporates this new policy, and the Committee believes that negotiating such a protocol with Austria should take priority over negotiating similar protocols with other countries.

B. STOCK GAINS

Under U.S. internal law, gains realized by a nonresident alien or a foreign corporation from the disposition of a capital asset, other than a U.S. real property interest, generally are not subject to U.S. tax unless the gain is effectively connected with a U.S. trade or business. The U.S. model and the OECD model reflect this policy. Under these model treaties, such gains derived by a resident of a treaty country from sources within the other country generally are taxed only by the recipient's country of residence (except gains connected with a real estate interest or a permanent establishment or a fixed base). In other words, a U.S. investor who realizes capital gain in a treaty country generally is taxable only by the United States.

The proposed treaty provides an exception to the above general rule. Under the proposed treaty, if a U.S. resident transfers property to an Austrian company as a capital contribution and, pursuant to the Austrian Reorganization Act ("Umgründungssteuergesetz"), the transfer is not subject to Austrian tax, a subsequent "alienation" of the shares in the Austrian company will be taxable in Austria if such alienation occurs through the year 2010. According to the Treasury Department's Technical Explanation of the proposed treaty (hereinafter referred to as the "Technical Explanation"), this rule applies to the disposition of stock of an Austrian company that was received upon the incorporation of a permanent establishment in Austria if the capital gains inherent in the property transferred to the Austrian company were not taxed at the time of the incorporation.

The term "alienation" is defined broadly for this purpose to include any transfer of property.⁴ For example, a subsequent contribution of the stock of the Austrian company that is the transferee of the property (from the U.S. transferor) to the capital of another company would constitute an alienation, and the appreciation in the stock of the Austrian company would be subject to Austrian tax under the proposed treaty.

This provision could be viewed as a one-sided concession by the United States that is inconsistent with the preferred U.S. tax treaty position which, as stated above, generally grants the residence country the exclusive right to tax non-business capital gains derived by its residents from the other country.

In addition, the provision also creates a potential double taxation problem for the U.S. taxpayer that transferred property to an Aus-

⁴Thus, a transfer may qualify as an alienation for Austrian tax purposes even though such transfer qualifies as a nonrecognition transaction for U.S. tax purposes.

trian company as a capital contribution. In the event that a subsequent transfer of the stock of such an Austrian company is treated as an “alienation” for Austrian tax purposes, the transfer would be taxable in Austria. However, if the subsequent transfer qualifies as a tax-free transaction in the United States, it would not be taxable in the year of the transfer and the U.S. tax on the appreciation in the stock of the Austrian company would be deferred until a later year. Consequently, the Austrian tax paid with respect to this transfer may not be available to offset the U.S. tax on the gain in the stock of the Austrian company (imposed in a subsequent year when the gain on such stock is recognized in a taxable transaction for U.S. tax purposes).⁵

In the event that the transfer is treated as an “alienation” for Austrian tax purposes, and if the transfer is taxable in the United States and Austria in the same year, double taxation still may occur because the gain generally is treated as U.S.-source income.⁶ Under the U.S. foreign tax credit rules, foreign taxes paid or accrued by a taxpayer are allowed to reduce only U.S. taxes on foreign-source income. Consequently, the Austrian taxes paid on the transfer of the stock of the Austrian subsidiary would not be allowed to reduce the U.S. gain from the same transaction, resulting in double taxation of the same gain, unless other relief is available.⁷

As part of its consideration of the proposed treaty, the Committee asked the Treasury Department whether the provision in the proposed treaty is appropriate as a matter of U.S. treaty policy. The relevant portion of the Treasury Department’s October 8, 1997 letter⁸ responding to this inquiry is reproduced below:

[O]ur current tax convention with Austria (which dates from 1957) has no provision reserving to the residence country the right to source gain from the disposition of shares. Therefore, Austria now has the right to tax such gain. In the proposed treaty, Austria was willing to adopt a provision that gives up its right to tax stock gains at source. In securing this concession from Austria, we agreed to a transition rule in the pending convention preserving Austria’s right to tax gain through the year 2010—a rule covering a very limited number of cases. This transition rule is limited to the disposition of stock that was received on the incorporation of a permanent establishment in Austria if the capital gains were not taxed on the incorporation of the subsidiary.

We do not consider this provision to be a one-sided concession. Rather we believe that accepting the limited transition rule in the treaty was necessary in order to move over the long run to a provision that is fully consistent with U.S. tax treaty policy. We believe that our acceptance of such a transition rule in this case will not be misconstrued as a retreat from our support for the position we take in the U.S. Model.

Although the proposed treaty represents a limited departure from U.S. tax treaty policy, the Committee believes that the provision represents a substantial improvement from the present treaty. This provision should not stand as a model for other treaty negotiations, however. In negotiating future treaties, the Treasury Department should continue to seek provisions that conform more closely

⁵ However, the Austrian tax paid may be carried back two years or carried forward five years to offset U.S. tax imposed on a similar type of foreign-source income under U.S. internal law.

⁶ Under certain circumstances, such gain may, however, qualify as foreign-source income.

⁷ The Technical Explanation states that it is expected that any such double taxation would be addressed by the competent authorities.

⁸ Letter from Joseph H. Guttentag, International Tax Counsel, Treasury Department, to Senator Paul Sarbanes, Committee on Foreign Relations, October 8, 1997 (“October 8, 1997 Treasury Department letter”).

to the U.S. model in generally providing for exclusive residence-country taxation of stock gains.

C. ROYALTIES

The present treaty contains a two-tier limitation on source-country taxation of royalties: (1) royalty payments for motion picture film rentals may be taxed by the source country at a rate of 10 percent; and (2) all other royalty payments are exempt from source-country taxation. The proposed treaty maintains the two-tier limitation of the present treaty, but modifies the treatment of royalties in two ways.

First, the proposed treaty modifies the definition of the term "royalties" to exclude rentals and like payments for the use of industrial, commercial or scientific equipment. Such payments generally are treated as business profits under the proposed treaty.⁹ Consequently, a U.S. resident would not be subject to Austrian income tax on amounts paid for the use of industrial, commercial or scientific equipment in Austria unless such amounts are attributable to a permanent establishment that the U.S. resident has in Austria. If the amounts are attributable to an Austrian permanent establishment, then the U.S. resident would be subject to Austrian tax on such amounts in the same manner that an Austrian resident that derives the same income would be taxed.

Second, the proposed treaty expands the class of royalty payments that are subject to the 10-percent source-country taxation. Under the present treaty, only motion picture film rentals are subject to source-country taxation. Under the proposed treaty, source-country taxation also applies to payments for the use of, or the right to use, tapes or other means of reproduction used for radio or television broadcasting. Consequently, a significantly expanded class of Austrian-source royalties beneficially owned by U.S. residents will be subject to a 10-percent Austrian withholding tax under the proposed treaty. Such withholding taxes generally may be allowed to reduce the U.S. income tax imposed on the same or similar income. Accordingly, this increased class of Austrian royalty payments that are subject to a creditable 10-percent Austrian tax represents an expansion of the instances in which the United States cedes its taxing jurisdiction to Austria.

By contrast, U.S. treaty policy, as reflected in the U.S. model and in many U.S. treaties with developed nations, generally would eliminate the source-country tax on royalties. The Committee noted during its consideration of the present treaty in 1957 that the treaty "differs from a number of other tax treaties which provide a complete exemption for film rentals."

As part of its consideration of the proposed treaty, the Committee asked the Treasury Department whether the expansion under the proposed treaty of the 10-percent source-country tax on royalties is appropriate as a matter of U.S. treaty policy. The relevant portion of the October 8, 1997 Treasury Department letter responding to the inquiry is reproduced below:

Because we had accepted the 10-percent rate at source on movie royalties under the current U.S.-Austria tax convention and because we wanted to improve the cur-

⁹See 1992 OECD Commentary on Article 12, paragraph 9.

rent tax treaty in several other respects, we concluded that the best approach under the circumstances was to continue to accept the provision on film royalties. Realistically, because of technological and economic developments, this meant extending the rule to include radio and television broadcasting royalties. For example, it would be administratively difficult to distinguish between royalties relating to different broadcasting rights. In addition, distinguishing among these sectors would have created an uneven playing field within the entertainment industry. In negotiating the provision, we not only took into account the royalty income flows between our two countries but recognized that many of Austria's treaties, including several with OECD member countries, retain some source-country tax rights for royalties.

Although the Committee understands the reasons for expanding source-country taxation for royalties in this case, the Committee remains concerned that this provision represents a significant step backward from the present treaty. Its effect will be to cede taxing jurisdiction from the United States to Austria. The Committee believes that in updating existing tax treaties the Treasury Department should reject changes that would lessen the treaty's overall benefit to the United States. The Committee also is concerned by the precedent this provision may present for future treaty partners that may seek provisions allowing source-country taxation of royalties. Although the Committee does not believe that the treatment of such royalties warrants a reservation to, or rejection of, the proposed treaty, such a provision could be cause for such action in future treaties, particularly treaties with OECD member countries. The Treasury Department should continue to seek provisions that conform more closely to the U.S. model in exempting royalties from source-country taxation.

D. EXCHANGE OF INFORMATION

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

The exchange of information article contained in the proposed treaty generally conforms to the corresponding articles of the U.S. and OECD models. As is true under these model treaties and the present treaty, under the proposed treaty a country is not required to carry out administrative measures at variance with the laws and administrative 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 discloses any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which is contrary to public policy. The MOU provides that provisions on bank secrecy do not constitute a professional, trade, business, industrial, or commercial secret.

The Technical Explanation states that Austrian bank secrecy laws prohibit Austrian tax authorities from obtaining information from Austrian banks for their own non-penal tax investigations and proceedings. Consequently, the Austrian competent authority generally would not be able to provide such information upon the request of the U.S. competent authority in connection with a non-penal tax investigation or proceeding in the United States. However, the proposed treaty provides that the Austrian competent au-

thority may obtain Austrian bank information in connection with a U.S. penal investigation. According to the MOU, the term “penal investigations” applies to proceedings carried out by either judicial or administrative bodies, such as the commencement of a criminal investigation by the Criminal Investigation Division of the Internal Revenue Service (the “IRS”). Therefore, this special provision enables the United States to obtain Austrian bank information in connection with criminal investigations without violating Austrian internal law. However, as under the present treaty, because of Austrian internal law, the United States may not obtain Austrian bank information in situations that are not in connection with a criminal investigation.

As part of its consideration of the proposed treaty, the Committee asked the Treasury Department about the adequacy of the exchange of information provisions in the proposed treaty. The relevant portion of the October 8, 1997 Treasury Department letter is reproduced below:

[T]he proposed treaty improves the ability of the United States to obtain information for the enforcement of U.S. tax laws and the prevention of tax avoidance and evasion. We were able to obtain assurance from Austria that the commencement of a criminal investigation by the Criminal Investigation Division of the Internal Revenue Service constitutes a penal investigation under Austrian domestic law. The establishment of a clear point for obtaining account information at a stage that is early enough to be useful in key cases is a major step forward under our pending treaty. Further, under our pending treaty, Austria is undertaking to do something else that it has not done for any other treaty partner. Austria will use its power of search and seizure in connection with a penal proceeding to obtain information under our pending treaty in connection with a penal proceeding in the United States.

Although broader exchange of information provisions are desirable, the Committee understands the difficulty in achieving broader provisions given the current constraints of Austrian law and practices. Moreover, the Committee understands that the information exchange provisions of the proposed treaty represent a significant improvement over those of the present treaty. However, the Committee does not believe that the proposed Austrian treaty should be construed in any way as a precedent for other negotiations. The exchange of information provisions in treaties are central to the purposes for which tax treaties are entered into, and significant limitations on their effect, relative to the preferred U.S. tax treaty position, should not be accepted in negotiations with other countries that seek to have or to maintain the benefits of a tax treaty relationship with the United States.

E. OECD COMMENTARY

The MOU includes a special provision with respect to the interpretation of the proposed treaty. Under this provision, the OECD Commentary is to apply in interpreting any provision of the proposed treaty that corresponds to a provision of the OECD model. However, this general rule does not apply if either the United States or Austria has entered into a reservation or has included an observation with respect to the OECD model or its Commentary. In addition, this rule also does not apply if a contrary interpretation is included in the MOU, or a published interpretation of the proposed treaty (e.g., the Technical Explanation) has been provided

by one country to the competent authority of the other country before the proposed treaty enters into force, or has been agreed to by the competent authorities after the proposed treaty has entered into force. In other words, unless specifically stipulated by either or both countries, the relevant OECD Commentary generally is controlling in the interpretation of provisions of the proposed treaty.

The proposed treaty contains the standard provision that unless the context otherwise requires or the competent authorities of the two countries establish a common meaning, all terms not defined in the treaty are to have the meanings which they have under the laws of the country applying the treaty (Article 3, paragraph 2 (General Definitions)). Because this standard provision is part of the text of the proposed treaty, it overrides the provisions of the MOU in the event of a conflict. Thus, for example, if a term of the proposed treaty is not defined in the treaty, but is defined in U.S. internal law, and the same term also is defined in the OECD Commentary, and the United States and Austria have not stipulated otherwise, the definition provided by U.S. internal law would control.

Other U.S. income tax treaties and protocols occasionally have required that a specific provision of an income tax treaty be interpreted in accordance with the OECD Commentary to the corresponding provision of the OECD model.¹⁰ However, no U.S. treaty has ever required the treaty countries to interpret the provisions of the treaty broadly in accordance with the OECD Commentary.

As part of its consideration of the proposed treaty, the Committee asked the Treasury Department whether the self-executing nature of this provision could have the effect of modifying the substantive rules of the proposed treaty without the usual ratification procedures of either country. The relevant portion of the October 8, 1997 Treasury Department letter responding to this inquiry is reproduced below:

This provision cannot create a substantive amendment to the proposed convention as adopted by both countries under their usual ratification procedures. Rather the provision utilizes an additional tool (the OECD Commentary) in interpreting the provisions of the Convention. The OECD Commentary would be useful in interpreting most of the provisions of the proposed Convention to a greater or lesser extent. Of course, the MOU and the Treasury Technical Explanation have precedence over the OECD commentaries, now and in the future.

Neither country is bound by OECD Commentary to the extent that its disagreement with the Commentary is indicated at any time by observation or reservation. Therefore, the United States is not required to interpret a provision in a manner inconsistent with U.S. law or U.S. tax treaty policy. However, the ability to enter a reservation or observation to the OECD Commentary does not give either party a unilateral right to override the treaty because one country's reservation or observation does not bind the other. If the OECD Commentary, because of observations, and other interpretive sources do not resolve an issue, the competent authorities may attempt to do so.

The Committee understands that the proposed treaty, as interpreted by the MOU, does not permit either country to make substantive amendments to the proposed treaty without ratification. The Committee also understands that the provision does not per-

¹⁰For example, Provision 19 of the Protocol to the 1990 U.S.-Spain income tax treaty requires the two countries to interpret Article 27 (Exchange of Information and Administrative Assistance) of that treaty in a manner consistent with the Commentary to the corresponding provision of the 1977 OECD model treaty.

mit the OECD Commentary to override U.S. law or U.S. tax treaty policy. In order to make this point clear, the Committee has included in its recommended resolution of ratification an understanding regarding the ability of the United States to enter a reservation or observation to the OECD model or its Commentary at any time.

F. INCOME FROM SLEEPING PARTNERSHIPS (STILLE GESELLSCHAFT)

The proposed treaty contains a special rule which treats income derived from an Austrian “sleeping partnership” (Stille Gesellschaft) by a U.S. “sleeping partner” as business profits attributable to the permanent establishment of the partnership in Austria. According to the Technical Explanation, there are two types of sleeping partnerships under Austrian tax law: the “typical” form and the “non-typical” form. The profits of a sleeping partner in a typical sleeping partnership generally are treated as income from investment activities for Austrian tax purposes. On the other hand, the profits of a sleeping partner of a non-typical sleeping partnership are treated as income from commercial activities for Austrian tax purposes. Whether a particular sleeping partnership should be characterized as typical or non-typical under Austrian tax law may not be clear.

German internal law also provides for sleeping partnerships. The 1989 U.S.-Germany income tax treaty provides that income from a sleeping partnership may be taxed in accordance with internal German tax law, without regard to the reduction in the tax rate otherwise applicable to dividends provided by that treaty, if such amount is deductible in computing the profits of the sleeping partnership.¹¹

As part of its consideration of the proposed treaty, the Committee asked the Treasury Department whether the proposed treaty’s characterization of the profits from an Austrian sleeping partnership as business profits is appropriate, given that the U.S.-Germany treaty provides for different treatment of profits from similar entities under German law. The relevant portion of the October 8, 1997 Treasury Department letter responding to this inquiry is reproduced below:

The domestic laws of Germany and Austria differ in how they tax income from one form of silent or sleeping partnership—the typical sleeping partnership. Austria requires a nonresident sleeping partner to declare the income and imposes tax on the income on a net basis. Germany imposes a withholding tax in full and final settlement of the sleeping partner’s tax liability. The German and the pending Austrian treaty reflect this difference in their treatment of income from a typical sleeping partnership.

Under the proposed Austrian treaty, in the case of either type of sleeping partnership arrangement (typical or non-typical), there is only one level of tax imposed on the income. In the typical sleeping partnership arrangement, the income of the silent partner is deductible to the other partner; and, in the non-typical sleeping partnership arrangement, the other partner is entitled to exclude from income the amounts allocable to the silent partner.

As described above, profits from Austrian sleeping partnerships generally are taxed on a net basis under Austrian law, similar to the treatment of business profits under the proposed treaty. Accordingly, the Committee believes that the treatment of profits

¹¹ See Article 10(5) of the 1989 U.S.-Germany income tax treaty.

from Austrian sleeping partnerships under the proposed treaty as business profits is appropriate.

G. TREATY SHOPPING

In general

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

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

Analysis of provisions

One provision of the anti-treaty-shopping article differs from the comparable rule of some earlier U.S. treaties, but the effect of the change is not completely clear. The general test applied by those earlier treaties for the allowance of benefits to an entity that does not meet the bright-line ownership and base erosion tests is a

broadly subjective one, turning on 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 denies the benefits of the treaty only in cases where the income is not derived in connection with, or incidental to, the active conduct of a trade or business.¹² 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.

Although the proposed treaty’s active business test is similar to that of other U.S. tax treaties, the proposed treaty provides greater detail than other treaties. In some cases, the proposed treaty mirrors provisions in the branch tax regulations, but may be more generous to taxpayers. In addition, like some recent U.S. treaties, the proposed treaty attributes to the treaty resident active trades or businesses conducted by other entities. The attribution rules in the proposed treaty may result in more taxpayers being eligible for treaty benefits, and permit certain third-country business operations to be treated as if they were carried on in Austria. These rules are similar to those in the U.S.-Netherlands treaty and the U.S.-France treaty.

The proposed treaty includes a special rule designed to prevent the proposed treaty from reducing or eliminating U.S. tax on income of an Austrian resident in a case where no other substantial tax is imposed on that income (the so-called “triangular case”). This is necessary because an Austrian resident in some cases may be wholly or partially exempt from Austrian tax on foreign (i.e., non-Austrian) income. The special rule applies generally if the combined Austrian and third-country taxation of third-country income earned by an Austrian enterprise with a permanent establishment in the third country is less than 60 percent of the tax that would be imposed if the income were subject to tax in Austria.

Under the special rule, the United States is permitted to tax U.S.-source interest and royalties paid to the third-country permanent establishment in accordance with its internal law without regard to the treaty. There are several exceptions to this special rule. Under one of the exceptions, the special rule does not apply if the income is subject to U.S. taxation under the controlled foreign corporation rules.¹³ The special rule for triangular cases is not included in the U.S. model.

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

¹² However, this active trade or business test does not apply with respect to a business of making or managing investments carried on by a person other than a bank or insurance company, so that treaty benefits may be denied with respect to such a business regardless of whether it is an active trade or business.

¹³ These provisions are contained in sections 951-964 of the Code (referred to as the “subpart F” rules).

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 October 8, 1997 Treasury Department letter responding to this inquiry is reproduced below:

Unlike the existing Convention, the proposed Convention with Austria contains a comprehensive anti-treaty-shopping provision. A Memorandum of Understanding provides an interpretation of key terms. Austria's recent membership in the European Union and the special United States ties to Canada and Mexico under the North American Free Trade Agreement are an element in the determination by the competent authority of eligibility for benefits of certain Austrian and United States companies. Recognized headquarters companies of multinational corporate groups are entitled to benefits of the Convention under rules that are substantively identical to the parallel rule in the U.S.-France treaty reviewed by the Committee in 1995.

The proposed Convention also provides for the elimination of another potential abuse relating to the granting of United States treaty benefits in the so-called triangular cases to income of an Austrian resident attributable to third-country permanent establishments of Austrian corporations that are exempt from tax in Austria by operation of Austria's law or treaties. Under the proposed rule, full United States treaty benefits will be granted in these triangular cases only when the United States-source income is subject to a sufficient level of tax in Austria and in the third country. As in the U.S.-France treaty, this anti-abuse rule does not apply in certain circumstances, including when the United States taxes the profits of the Austrian enterprise under subpart F of the Internal Revenue Code.

Committee Conclusions

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 further believes 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 Austria since third-country investors may be unwilling to share ownership of such investing entities on a less-than-50-percent basis with U.S. or Austrian 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 an Austrian conduit. Finally, Austria imposes significant taxes of its own; these taxes may deter third-country investors from seeking to use Austrian 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 Austria is presented below. The MOU agreed to by the negotiators, and other matters set forth in diplomatic notes exchanged at the time the proposed treaty was signed, are covered together with the relevant articles of the proposed treaty.

Article 1. Personal Scope

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

Overview

The proposed treaty generally applies to residents of the United States and to residents of Austria, with specific modifications to such scope in other articles (e.g., Articles 23 (Non-discrimination) and Article 25 (Exchange of Information and Administrative Assistance)).

The proposed treaty provides that it generally does not restrict any exclusion, exemption, deduction, credit or other allowance accorded by internal law or by any other agreement between the United States and Austria. Thus, the proposed treaty will apply only where it benefits taxpayers. As discussed below in 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 Austria 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 incurs 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.¹⁴

Coordination with dispute resolution procedures of other agreements

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

Saving clause

Like all U.S. income tax treaties, the proposed treaty is subject to a "saving clause." Under this clause, with specific exceptions described below, the proposed treaty is not to affect the taxation by either treaty country 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 Austria as if the proposed 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 tie-breaker provisions governing dual residents (as defined in Article 4 (Resident)).

Like the U.S. model, the proposed treaty contains a provision under which the saving clause (and therefore the U.S. jurisdiction to tax) applies to a former U.S. citizen whose loss of citizenship had as one of its principal purposes the avoidance of tax; such application is limited to the ten-year period following the loss of citizenship. Prior to the enactment of the Health Insurance Portability and Accountability Act of 1996, section 877 of the Code provided special rules for the imposition of U.S. income tax on former U.S. citizens for a period of ten years following the loss of citizenship; these special tax rules applied to a former citizen only if his or her loss of U.S. citizenship had as one of its principal purposes the avoidance of U.S. income, estate or gift taxes. The Health Insurance Portability and Accountability Act of 1996 expanded section 877 in several respects. Under these amendments, the special income tax rules of section 877 were extended to apply also to certain former long-term residents of the United States. For purposes of applying the special tax rules to former citizens and long-term resi-

¹⁴ See Rev. Rul. 84-17, 1984-1 C.B. 308.

dents, individuals who meet a specified income tax liability threshold or a specified net worth threshold generally are considered to have lost citizenship or resident status for a principal purpose of U.S. tax avoidance. In addition, an expanded foreign tax credit is provided with respect to the U.S. tax imposed under these rules. The amendments to section 877 generally are applicable to individuals whose loss of U.S. citizenship or U.S. resident status occurred on or after February 6, 1995. The proposed treaty provision reflects the reach of the U.S. tax jurisdiction pursuant to section 877 prior to its expansion by the Health Insurance Portability and Accountability Act of 1996. Accordingly, the saving clause in the proposed treaty does not permit the United States to impose tax on former U.S. long-term residents who otherwise would be subject to the special income tax rules contained in the Code.

Exceptions to the saving clause are provided for the following benefits conferred by the proposed treaty: correlative adjustments to the income of enterprises associated with other enterprises the profits of which were adjusted by the other country (Article 9, paragraph 2); exemption from residence-country tax (or in the case of the United States, citizenship country tax) on gain accrued from the disposition of certain business assets (Article 13, paragraph 4); exemption from residence-country tax (or in the case of the United States, citizenship country tax) on social security benefits and alimony (Article 18, paragraphs 1(b) and 3); relief from double taxation (Article 22); nondiscrimination (Article 23); and mutual agreement procedures (Article 24).

In addition, the saving clause does not apply to certain benefits conferred by one of the countries with respect to an individual who is neither a citizen of the conferring country nor, in the case of the United States, someone who has "immigrant status." Under this rule, for example, such treaty benefits are available to an Austrian citizen who spends enough time in the United States to be taxed as a U.S. resident under Code section 7701(b) (see discussion below in connection with Article 4 (Resident)), provided that the individual has not acquired U.S. immigrant status. The benefits that are subject to this rule are exemption from tax on compensation from government service to the other country (Article 19), exemption from host-country tax on certain income received by temporary visitors who are students and trainees (Article 20), and certain fiscal privileges of diplomatic agents and consular officers referred to in the proposed treaty (Article 26). An individual who has been admitted to the United States as a permanent resident under U.S. immigration laws (i.e., a "green card" holder) is considered to have "immigrant status" under the proposed treaty.

The exceptions to the saving clause in the proposed treaty generally are consistent with the U.S. model and recent U.S. treaties. By contrast, although the double taxation provisions in paragraph 1 of Article XV of the present treaty afford protection to citizens, residents and corporations with respect to tax imposed by their home country, the saving clause in the present treaty sets forth only three exceptions. The first exception applies to governmental employment income derived by a resident of the other country (Article XI, paragraph (1)). The second exception applies to remunera-

tion for teachers (Article XII). The third exception applies to remittances and maintenance for students and trainees (Article XIII).

Article 2. Taxes Covered

The proposed treaty generally applies to the income taxes of the United States and Austria.

In the case of the United States, the proposed treaty applies to the Federal income taxes imposed by the Code, but excluding social security taxes. Unlike many U.S. income tax treaties in force, but like the present treaty, the proposed treaty applies to the accumulated earnings tax and the personal holding company tax. In the case of Austria, the proposed treaty applies to the income tax (die Einkommensteuer) and the corporation tax (die Koerperschaftsteuer).

For purposes of the non-discrimination article (Article 23), the proposed treaty applies to taxes of all kinds imposed by the countries, including any taxes imposed by their political subdivisions or local authorities. In addition, for purposes of paragraphs 1 to 5 of the exchange of information and administrative assistance article (Article 25), the proposed treaty applies to taxes of all kinds imposed by the countries at the federal level.

The proposed treaty also contains a provision generally found in U.S. income tax treaties (including the present treaty) to the effect that it will apply 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. The competent authorities also are to notify each other of any official published material concerning the application of the treaty. This clause is similar to the U.S. model.

Article 3. General Definitions

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

The term "Austria" comprises the Republic of Austria.

The term "United States" means the United States of America, but does not include Puerto Rico, the Virgin Islands, Guam or any other U.S. possession or territory. When used in a geographical sense, it means the States and the District of Columbia. It also includes the territorial waters of the United States and the seabed and subsoil of the submarine areas adjacent to the territorial waters and over which the United States has exclusive rights, in accordance with international law, with respect to the exploration and exploitation of natural resources. Under the proposed treaty, these same areas are considered part of the United States for treaty purposes, 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 company, and any other body of persons. A "company" is any body corporate or any entity which is treated as a body corporate for tax purposes.

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

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

The Austrian competent authority is the Federal Minister of Finance or his delegate. 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 establish a common meaning, all terms not defined in the treaty are to have the meanings which they have under the laws of the country applying the treaty. The MOU includes a special provision with respect to the interpretation of the proposed treaty. Generally, the OECD Commentary is to apply in interpreting any provision of the proposed treaty that corresponds to a provision of the OECD model.¹⁵ However, this general rule does not apply if either the United States or Austria has entered a reservation or has included an observation with respect to the OECD model or its Commentary. In addition, this rule also does not apply if a contrary interpretation is included in the MOU or a published interpretation of the proposed treaty (e.g., the Technical Explanation) that has been provided to the competent authorities of both countries or has been agreed to by the competent authorities. The Technical Explanation clarifies that the Technical Explanation overrides a different interpretation in the OECD Commentary, even where the OECD Commentary is adopted subsequent to the issuance of the Technical Explanation.

Article 4. Resident

In general

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

Under U.S. law, residence of an individual is important because a resident alien is taxed on worldwide income, while a nonresident alien is taxed only on certain U.S.-source income and on income that is effectively connected with a U.S. trade or business. An indi-

¹⁵The applicability of the OECD Commentary to the proposed treaty is consistent with the Vienna Convention on the Law of Treaties of May 23, 1969 (the “Vienna Convention”). The United States has not yet ratified the Vienna Convention.

vidual 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.

The proposed treaty generally defines “resident of a Contracting State” to mean any person who, under the laws of that country, is liable to tax in that country by reason of his or her domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature. A U.S. citizen or a green-card holder who is not a resident of Austria is treated as a U.S. resident under the proposed treaty only if the individual has a substantial presence, permanent home, or habitual abode in the United States. Consistent with most U.S. income tax treaties, citizenship alone does not establish residence. As a result, U.S. citizens residing overseas are not necessarily entitled to the benefits of the proposed treaty as U.S. residents. The Technical Explanation provides that the term “substantial presence” under the proposed treaty is a similar concept to “substantial presence” under Code section 7701(b); “permanent home” and “habitual abode” are terms frequently used in treaty “tie-breaker” rules, as described below.

The term “resident of a Contracting State” does not include any person who is liable to tax in that country in respect only of income from sources in that country. In the case of income derived by, or paid by, a partnership, estate or trust, the term applies only to the extent that the income it derives is subject to that country’s tax as the income of a resident, either in its hands or in the hands of its partners, beneficiaries or grantors. For example, if the U.S. beneficiaries’ share in the income of a U.S. trust is only one-half, Austria would have to reduce its withholding tax pursuant to the proposed treaty on only one-half of the Austrian-source income paid to the trust. The MOU provides that a similar test applies in determining the residence of other pass-through entities, such as limited liability companies.

According to the Technical Explanation, it is understood that a tax-exempt organization, including a pension trust, that is established under the laws of the United States or Austria is treated as a resident of the country under the laws of which it is established for purposes of the proposed treaty.

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

Dual residents

Individuals

A set of “tie-breaker” rules is provided to determine residence in the case of an individual who, under the basic residence rules,

would be considered to be a resident of both countries. Such a dual resident individual will be 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 or in neither country, the individual's residence is deemed to be the country with which his or her personal and economic relations are closer (i.e., the "center of vital interests"). The MOU provides that the center of vital interests may not be determinable solely by reviewing the circumstances prevailing in one single year; a longer period may have to be taken into consideration. If the country in which the individual has his or her center of vital interests cannot be determined, 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 of them, the competent authorities of the countries are to settle the question of residence by mutual agreement.

Entities

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 under the laws of which the company was created. This rule conforms with U.S. internal law.

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, like the U.S. model, requires the competent authorities of the two countries to determine by mutual agreement the residence of such person and the mode of application of the 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 an enterprise engages in business. A permanent establishment includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources. It also includes any building site or construction or installation project or an installation or drilling rig or ship used for

the exploration or development of natural resources if the site or project lasts for more than 12 months. 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. The 12-month period for establishing a permanent establishment in connection with a site or project corresponds to the rule of the U.S. model.

The 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 will 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 further include 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 refers to advertising and supplying information as examples of activities that are of a preparatory or auxiliary character. 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 will not constitute a permanent establishment.

If a person has, and habitually exercises, the authority to conclude contracts in a country on behalf of an enterprise of the other country, the enterprise generally is 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. and OECD models, 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 fact that a company that is resident in one country is related to a company that is a resident of the other country or to a company that engages in business in that other country does not of itself cause either company to be a permanent establishment of the other.

Article 6. Income from Real Property

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 real property situated in the other country may be taxed in the country where the real property is located. Income from real property includes income from agriculture or forestry.

The term “real property” generally has the meaning that it has under the law of the country in which the property in question is situated. The term in any case includes property accessory to real property; livestock and equipment used in agriculture and forestry; rights to which the provisions of general law respecting landed property apply; usufruct of real 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. Thus, income from real property includes royalties and other payments in respect of the exploitation of natural resources (e.g., oil). Ships, boats and aircraft are not real property. This definition corresponds to the definition of real property in the OECD model.

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

The MOU clarifies that the source country may tax the income derived from the exploitation of rights in real property. For example, a U.S. person that is a lessee of real property situated in Austria is subject to Austrian tax on the income derived from any sublease of the same property, even though the U.S. person is not the owner of the real property.

The present treaty permits the source country to tax interest on mortgages secured by real property under this article. The proposed treaty eliminates this rule and treats such interest in the same way as other types of interest, which generally is free from source-country tax (see Article 11).

Like the U.S. model and certain other U.S. income tax treaties, the proposed treaty provides residents of one country with an election to be taxed on a net basis by the other country on income from real property in that other country. U.S. internal law provides such a net-basis election in the case of income of a foreign person from U.S. real property income (Code secs. 871(d) and 882(d)). The proposed treaty provides that any such election shall be binding for the taxable year of the election and all subsequent taxable years, unless the competent authorities of the treaty countries agree to terminate the election pursuant to a request by the taxpayer made to the competent authority of the country in which the taxpayer is resident.

Article 7. Business Profits

U.S. internal law

U.S. law distinguishes between the U.S. business income and other U.S. income of a nonresident alien or foreign corporation. A nonresident alien or foreign corporation is subject to a flat 30-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 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 business is effectively connected with the conduct of a trade or business within the United States is made as if the sale or exchange occurred immediately before the cessation of business (Code sec. 864(c)(7)).

Proposed treaty limitations on internal law

Under the proposed treaty, business profits of an enterprise of one country are taxable in the other country only to the extent that they are attributable to a permanent establishment in the other country through which the enterprise carries on business. The taxation of business profits under the proposed treaty differs from U.S. rules for taxing business profits primarily by requiring more than merely being engaged in a trade or business before a country can tax business profits and by substituting an “attributable to” standard for the Code’s “effectively connected” standard.¹⁶ 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.

¹⁶ However, some articles of the proposed treaty use the phrase “effectively connected”; see, e.g., Article 10 (Dividends).

The present treaty contains a force of attraction rule similar to that in the Code as described above. The proposed treaty eliminates this rule. The proposed treaty is consistent with the U.S. and OECD models and other existing U.S. treaties in this respect.

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

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

Business profits will not be 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 will not be increased by the profit element with respect to its purchasing activities.

The amount of profits attributable to a permanent establishment must be determined by the same method each year unless there is good and sufficient reason to change the method. Where business profits include items of income which are dealt with separately in other articles of the treaty, those other articles, and not the business profits article, will govern the treatment of such items of income. Thus, for example, dividends are taxed under the provisions of Article 10 (Dividends), and not as business profits, except as provided in paragraph 6 of Article 10.

Under the proposed treaty, the term "business profits" includes income from the rental of tangible personal property. Under the

present treaty, income from the rental of certain tangible personal property is treated as royalties.

The proposed treaty contains a special rule which treats income derived from an Austrian “sleeping partnership” (Stille Gesellschaft) by a U.S. “sleeping partner” as business profits attributable to the permanent establishment of the partnership in Austria. According to the Technical Explanation, a sleeping partnership is a contract concluded under commercial law by which an investor (the sleeping partner) contributes money or money’s worth to the business of the contracting partner in exchange for a share in the profits of the business and the right to obtain specified information about the development of the business. The sleeping partner may agree under the contract to bear a portion of the losses of the business.

The Technical Explanation states that there are two types of sleeping partnerships under Austrian tax law: the typical form and the non-typical form. In a typical sleeping partnership, a sleeping partner does not participate in the capital and assets of the business, and his rights upon withdrawal from the partnership are limited to the return of his investment. The profits of a sleeping partner in a typical sleeping partnership generally are treated as income from investment activities for Austrian tax purposes. In a non-typical sleeping partnership, a sleeping partner is entitled to participate in the increase in net wealth of the business property as well as profits and losses of the business. Unlike profits in a typical sleeping partnership, the profits of a sleeping partner in a non-typical sleeping partnership are treated as income from commercial activities for Austrian tax purposes. Whether a particular sleeping partnership should be characterized as typical or non-typical under Austrian tax law may be unclear.

Under the proposed treaty, any income earned during the existence of and attributable to a permanent establishment or fixed base is taxable in the country where that permanent establishment or fixed base is situated, even if the payments with respect to such income are deferred until such permanent establishment or fixed base has ceased to exist. Thus, the proposed treaty permits the United States to apply the principles of Code section 864(c)(6) to the profits that rely for their taxability upon a nexus with a permanent establishment or fixed base. The proposed treaty rule that corresponds to the rule of Code section 864(c)(7) is discussed below in connection with the taxation of capital gains (Article 13).¹⁷

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

¹⁷This rule applies to business profits (Article 7, paragraphs 1 and 2), dividends (Article 10, paragraph 4), interest (Article 11, paragraph 3), royalties (Article 12, paragraph 4), capital gains (Article 13, paragraph 3), independent personal services (Article 14), and other income (Article 21, paragraph 2).

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

Under the proposed treaty, profits which are derived by an enterprise of one country from the operation in international traffic of ships or aircraft (“shipping profits”) are taxable only in that country, regardless of the existence of a permanent establishment in the other country. The proposed treaty defines “international traffic” as any transport by a ship or aircraft operated by an enterprise of one of the treaty countries, except when the ship or aircraft is operated solely between places in one of the treaty countries (Article 3(1)(d)(General Definitions)). Accordingly, with respect to an Austrian enterprise, purely domestic transport in the United States is excluded. The present treaty exempts all profits derived by an enterprise from the operation of ships or aircraft from source-country tax.

For purposes of the proposed treaty, shipping profits include rental income from full or bareboat leases of ships or aircraft, if such ships or aircraft are operated in international traffic by the lessee or if the rental income is incidental to profits from the operation of ships or aircraft in international traffic. Thus, the exemption from source-country tax for shipping profits applies to a bareboat lessor (such as a financial institution or a leasing company) that does not operate ships or aircraft in international traffic, but that leases ships or aircraft for use in international traffic.

According to the Technical Explanation, exemption also is available for profits from the inland transport of property or passengers within a country if such transport is undertaken as part of international traffic. Like the U.S. model, the proposed treaty expressly provides that income derived by an enterprise of one country from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) used in international traffic is exempt from tax by the other country. The Technical Explanation states that the same rule applies to a such income derived by a resident of either country through a partnership or other pass-through entity.

The shipping and air transport provisions of the proposed treaty, other than the foregoing provisions with respect to income from container leasing, 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. The Technical Explanation clarifies that container leasing profits, which are supplementary or incidental to the operation of international traffic of ships or aircraft, from the participation in a pool, a joint business or an international operating agency also are exempt from source-country tax.

Article 9. Associated Enterprises

The proposed treaty, like most other U.S. tax treaties, contains an arm’s-length pricing provision. The proposed treaty recognizes

the right of each country to determine the profits taxable by that country in the case of transactions between related enterprises, if the profits of an enterprise do not reflect the conditions which would have been made between independent enterprises. The proposed treaty provides that it is understood, however, that the fact that associated enterprises have concluded arrangements, such as cost-sharing arrangements or general services agreements, for or based on the allocation of executive, general administrative, technical and commercial expenses, research and development expenses, and other similar expenses, is not in itself a condition giving rise to this right.

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

Like the present Austrian treaty and the U.S. and OECD models, the proposed treaty does not include the paragraph contained in many other U.S. tax treaties which provides that the rights of the treaty countries to apply internal law provisions relating to adjustments between related parties are fully preserved. Nevertheless, the Technical Explanation provides that the respective countries retain the right to apply their internal intercompany pricing rules (e.g., Code sec. 482, in the case of the United States).

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. This "correlative adjustment" clause has no counterpart in the present treaty. In making that adjustment, due regard is to be given to other provisions of the treaty and the competent authorities of the two countries will consult with each other if necessary. For example, under the mutual agreement article (Article 24), a correlative adjustment cannot necessarily be denied on the ground that the time period set by internal law for claiming a refund has expired. To avoid double taxation, the proposed treaty's saving clause retaining full taxing jurisdiction in the country of residence or nationality (discussed above in connection with Article 1 (Personal Scope)) will not apply in the case of such adjustments.

Article 10. Dividends

Overview

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

Finally, the proposed treaty expressly permits the United States to collect a 5-percent branch profits tax from an Austrian company.

U.S. internal law

Dividends and second-level withholding tax

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

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

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

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

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

A REIT is organized to allow persons to diversify ownership in primarily passive real estate investments. As such, the principal income of a REIT often is rentals from real estate holdings. Like

dividends, U.S.-source rental income of foreign persons generally is subject to the 30-percent withholding tax (unless the recipient makes an election to have such rental income taxed in the United States on a net basis at the regular graduated rates). Unlike the withholding tax on dividends, however, the withholding tax on rental income generally is not reduced in U.S. income tax treaties.

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

U.S. branch profits tax rules

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

Austrian internal law

Austria generally imposes a 25-percent withholding tax on certain Austrian-source payments that include dividends. The withholding tax generally applies to dividends, other corporate distributions, and interest on profit-sharing and convertible bonds by an Austrian corporation whether paid to individual or corporate residents or nonresidents. The withholding tax does not apply to a dividend paid to a foreign corporation residing in a European Union ("EU") member country, if the dividend is subject to Austrian tax law provisions enacted in response to the so-called "parent-subsidiary directive" approved by the EC Council of Ministers on July 23, 1990.

Like U.S. corporate tax law, Austrian tax law generally embodies the so-called "classical system" under which corporate income may be taxed at the corporate level, and then taxed again at the shareholder level upon a distribution. A participation exemption is available if the recipient company owns 25 percent or more of the share capital of the payor company directly and continuously for at least 12 months prior to the end of the taxable year in which the dividend is paid.

Austria does not impose a branch profits tax.

Proposed treaty limitations on internal law

Reduction of withholding tax

Under the proposed treaty, each country may tax dividends paid by its resident companies, but the rate of tax is limited by the pro-

posed treaty if the beneficial owner of the dividends is a resident of the other country. Source-country taxation generally is limited to 5 percent of the gross amount of the dividends if the beneficial owner of the dividends is a company (other than a partnership) which holds directly at least 10 percent of the voting shares of the payor company. Under the proposed treaty, the tax generally is limited to 15 percent of the gross amount of the dividends paid to residents of the other country in all other cases. Under the present treaty, source-country tax may be imposed at a 15-percent rate, rather than only a 5-percent rate, unless a higher ownership threshold is met (95-percent stock ownership by one recipient corporation residing in the other country).

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

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 an Austrian resident, if the beneficial owner of the dividend is either an individual holding a 10-percent-or-greater interest in the REIT or if the beneficial owner is not an individual. The MOU makes clear that such a dividend is taxable at the 30-percent United States statutory rate.

Definition of dividends

Unlike the U.S. and OECD models, the present treaty provides no express definition of the term “dividends”. The proposed treaty provides a definition of dividends that is broader than the definition in the U.S. model and some other recent U.S. treaties. Similar to the U.S. model, the proposed treaty generally defines “dividends” as income from shares or other rights (not being debt claims) participating in profits. Dividends also include income from other corporate rights that is subjected to the same tax treatment as income from shares by the country in which the distributing company is resident. The proposed treaty also provides (unlike the U.S. model) that the term dividends includes income from arrangements, including debt obligations, carrying the right to participate in profits, to the extent such income is characterized as dividends under the law of the country in which the income arises.

Special rules and exceptions

The proposed treaty’s reduced rates of tax on dividends do not apply if the recipient 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 holding on which the dividends are paid is effectively connected with the permanent establishment (or fixed base).

Dividends paid on such holdings of a permanent establishment or a fixed base is 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 9).

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

Branch profits tax

The proposed treaty allows the United States to impose the branch profits tax (as opposed to the branch-level excess interest tax (Code sec. 884(f)), described below) on an Austrian resident corporation that either has a permanent establishment in the United States, or is subject to tax on a net basis in the United States on income from real property or gains from the disposition of real property interests. Like the U.S. model, the proposed treaty permits at most a 5-percent branch profits tax rate, and, in cases where a foreign corporation conducts a trade or business in the United States, but not through a permanent establishment, the proposed treaty completely eliminates the branch profits tax that the Code imposes on such corporation.

In general, the proposed treaty provides that the branch profits tax may be imposed by the source country only on that portion of the business profits of the foreign corporation attributable to its source-country permanent establishment, or the corporation's real property income subject to tax on a net basis. In general, the branch profits tax also may be imposed by the source country on the foreign corporation's gains from the disposition of real property. The proposed treaty permits the United States to impose its branch profits tax on the "dividend equivalent amount" (as that term is defined under the Code as it may be amended from time to time) to the extent that this definition is in conformity with the principles of the branch tax article.

None of the restrictions on the operation of U.S. branch tax provisions apply, however, unless the corporation seeking treaty protection meets the conditions of the proposed treaty's limitation on benefits article (Article 16). 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 described above.

Article 11. Interest

U.S. internal law

Subject to numerous exceptions (such as those for portfolio interest, bank deposit interest, and short-term original issue discount), the United States imposes a 30-percent tax on U.S.-source interest paid to foreign persons under the same rules that apply to dividends. U.S.-source interest, for purposes of the 30-percent tax, generally is interest on the debt obligations of a U.S. person, other than a U.S. person that meets specified foreign business requirements. Also subject to the 30-percent tax is interest paid to a foreign person by the U.S. trade or business of a foreign corporation. A foreign corporation is also 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.

Austrian internal law

Austria generally does not impose any tax on interest income of nonresidents. As described above in connection with the dividend article (Article 10), the Austrian dividend tax applies to proceeds from profit sharing bonds, and under the proposed treaty, such proceeds are treated as dividends rather than interest for Austrian withholding purposes. In addition, a nonresident individual or cor-

poration may be subject to Austrian tax with respect to interest on loans secured by Austrian-situs real property.

Proposed treaty limitations on internal law

Elimination of withholding tax

The proposed treaty generally exempts from the U.S. 30-percent tax interest (within the proposed treaty's definition of that term) paid to Austrian residents. The proposed treaty also exempts from Austrian tax, where any such taxes are otherwise applicable, Austrian-source interest paid to U.S. residents. These reciprocal exemptions are similar to those in effect under the present treaty and in the U.S. model. According to the Technical Explanation, the proposed treaty also exempts Austrian corporations from imposition by the United States of the branch-level excess interest tax.

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

No such exemption applies to an excess inclusion with respect to a residual interest in a REMIC. Thus, such inclusions may be taxed at 30 percent under the proposed treaty. In addition, the proposed treaty does not prevent the United States from imposing its withholding tax on contingent interest that does not qualify as portfolio interest under U.S. law and to analogous types of interest under Austrian law.

Exemptions from source-country tax will not apply if the beneficial owner of the interest carries on a 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 obligation on which the interest is paid is effectively connected with 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 on an obligation that is effectively connected with a permanent establishment or fixed base which is 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 9).

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

Definition of interest

The proposed treaty defines interest generally as income from debt claims of every kind, whether or not secured by a mortgage and whether or not carrying a right to participate in the debtor's profits. In particular, it includes income from government securi-

ties and bonds or debentures, including premiums or prizes attaching to such securities, bonds, or debentures. The proposed treaty also defines interest to include an excess inclusion with respect to a REMIC. However, the term does not include income dealt with in the dividend article (Article 10). Thus, the interest exemption does not prevent Austria from imposing the dividend tax on interest paid on profit-sharing bonds. Penalty charges for late payment are not considered interest for purposes of the proposed treaty.

Article 12. Royalties

Internal law

Under the same system that applies to dividends and interest, the United States imposes a 30-percent tax on U.S.-source royalties paid to foreign persons, and on gains from the disposition of certain intangible property to the extent that such gains are from payments contingent on the productivity, use, or disposition of the intangible property. Royalties are from U.S. sources if they are for the use of property located in the United States. U.S.-source royalties include royalties for the use of or the right to use intangible property in the United States. Austria generally imposes a 20-percent tax on royalties derived by nonresidents.

Proposed treaty limitations on internal law

Reduction of withholding tax

The U.S. model exempts royalties beneficially owned by a resident of one country from source-based taxation in the other country, and defines the term “royalties” to include payments for the right to use intangible property including cinematographic films, audio or video tapes or disks and other means of image or sound reproduction. The U.S. model does not include in that term rental payments for the use of tangible personal property.

The present treaty differs from the U.S. model in that it permits source-country taxation of royalties. The present treaty covers rental payments for motion picture films and for the use of industrial, commercial or scientific equipment. The present treaty contains a two-tier limitation on source-country taxation of royalties. Only the residence country may tax royalties and similar payments in respect of the production or reproduction of literary, musical or other copyrights, artistic and scientific works, patents, designs, plans, secret processes and formulae, trademarks, and other like property and rights (including rentals and like payments for the use of industrial, commercial or scientific equipment). Motion picture film rentals may be taxed by the source country at a rate of 10 percent.

The proposed treaty maintains the two-tier limitation of the present treaty, but expands the class of payments that are subject to the 10-percent source-country tax. Under the proposed treaty, royalties that constitute consideration for the use of, or the right to use, cinematograph film or film, tapes or “other means of reproduction” used for radio or television broadcasting are subject to the 10-percent source-country tax. The Technical Explanation indicates that the phrase “other means of reproduction” is intended to refer to use of means of reproduction that reflect future technological advances in the field of radio and television broadcasting. All other

royalties arising in one treaty country and beneficially owned by a resident of the other country may be taxed only by the country of residence, and not by the country where the royalty arose. The exemption applies only if the royalty is beneficially owned by a resident of the other country; it does not apply if the recipient of the royalty is a nominee for a nonresident.

The exemption and the 10-percent withholding rate under the proposed treaty do not apply where the recipient carries on a business through a permanent establishment (or a fixed base, in the case of an individual who performs or performed independent personal services) in the source country and the property with respect to which the royalties are paid is effectively connected with the permanent establishment (or fixed base). In that event, the royalties are taxed as business profits (Article 7) or income from the performance of independent personal services (Article 14). In addition, royalties paid with respect to property which is effectively connected with 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 9).

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 will apply only to the amount of arm's-length royalties. Any amount of royalties paid in excess of the arm's-length royalty will be 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.

Definition of royalties and source rules

Under the proposed treaty, royalties are defined as payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work (including cinematograph films or films or tapes used for radio or television broadcasting), 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 a right or property described above which are contingent on the productivity, use, or disposition of such right or property. The term "industrial, commercial, or scientific experience" is defined in paragraph 11 of the Commentary to Article 12 of the OECD Model. According to the Commentary, the term may include information that is ancillary to a right otherwise giving rise to royalties, such as a patent or secret process. According to the Technical Explanation, payments for the use, or the right to use, computer software may be considered royalties under the proposed treaty or may be considered business profits, depending on the facts and circumstances. However, payments received in connection with the transfer of so-called "shrink-wrap" computer software are treated as business profits.

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

Article 13. Capital Gains

U.S. internal law

Generally, gain realized by a nonresident alien or a foreign corporation from the sale of a capital asset is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S. trade or business. Under a special rule, gain from the disposition of any property within 10 years after such property ceased to be used in a U.S. trade or business is treated as effectively connected with the U.S. trade or business (Code sec. 864(c)(7)).

In addition, 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.

Austrian internal law

Under Austrian law, the taxation of capital gains, of both residents and nonresidents, generally is limited to gains that are business income. However, a nonresident generally may be subject to Austrian tax (at ordinary rates) on gain from the disposition of shares issued by an Austrian corporation, if the person is treated as having a substantial interest (i.e., more than 10 percent) in the corporation. Under the present treaty, Austria retains the right to impose this tax in some limited cases on Austrian citizens who are U.S. residents.

Austrian law also provides for nonrecognition of gain that is realized upon certain exchanges of property or stock in connection with contributions of property to corporations, liquidations of corporations, distributions of stock, and corporate reorganizations. Austrian and U.S. nonrecognition provisions are not identical. For example, if a U.S. company has a permanent establishment in Austria and the company transfers the assets of the Austrian permanent establishment to a subsidiary, Austria generally will tax the unrealized gain at the time of the transfer unless the shares of the subsidiary remains subject to Austrian tax.

Proposed treaty limitations on internal law

Real property

Under the proposed treaty gains derived by a treaty country resident from the disposition of real property situated in the other country may be taxed in the other country. Real property situated in the other country for the purposes of this article includes real property referred to in Article 6 (Income from Real Property) which is situated in the other country. With respect to the United States, the term real property situated in the other country includes a "U.S. real property interest" as defined under the Code, and an interest in a partnership, trust, or estate, to the extent that such interest is attributable to real property situated in the United States.

The Committee understands 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)). With respect to Austria, the term includes shares or other comparable rights in a company the assets of which consist, directly or indirectly, mainly of real property situated in Austria.

Other capital gains

The proposed treaty contains a standard provision which permits a country to tax the gain from the alienation of personal property that forms part of the business property of a permanent establishment or fixed base of a resident of the other country located in the first country.

In addition, gains from the alienation of movable property previously used or held in connection with a permanent establishment or fixed base that a resident of one of the treaty countries has, or had, in the other country may be taxed by such other country, but only to the extent that the gain is attributable to the period in which the personal property in question formed part of the business property of the permanent establishment or fixed base. The residence country also may tax the gains associated with the same property; however, such country is required to exclude from its tax base any gain that is taxed by the source country. Thus, this provision is consistent with the internal Austrian rule that taxes the appreciation inherent in the business assets upon an incorporation of an Austrian permanent establishment. Although the provision is drafted reciprocally, the United States may not, under its domestic law, impose a tax on such an event. In addition, this provision is narrower than the rule of Code section 864(c)(7) because it limits the taxable gain to the amount accrued during the period the property was part of the permanent establishment or fixed base.

Gains of an enterprise of one of the treaty countries from the alienation of ships, aircraft or containers operated in international traffic are taxable only in that country. Gains described in the royalties article (i.e., gains derived from alienation of certain intangible property that are contingent on productivity, use, or disposition) are taxable only in accordance with that article (Article 12). Thus, such gains are either exempt from source-country tax or are subject to a 10-percent source-country tax.

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

Under the proposed treaty, where a U.S. resident transfers property to an Austrian company as a capital contribution and the transfer is not subject to Austrian tax (i.e., due to the application of the Austrian Reorganization Tax Act (“Umgründungssteuergesetz”)), a subsequent alienation of the shares in the Austrian company is taxable in Austria through the year 2010. The Technical Explanation states that it is expected that any double taxation that occurs as a result of treating a transfer of stock as an “alienation” for Austrian tax purposes would be addressed under the competent authority procedures.

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 a taxable year; (2) the compensation does not exceed \$3,000; and (3) the services are performed as an employee of, or under a contract with, a foreign person not engaged in a trade or business in the United States or are performed for a foreign office or place of business of a U.S. person.

Proposed treaty limitations on internal law

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

Under the proposed treaty, income from the performance of independent personal services by a resident of one country is exempt from tax in the other country, unless the services are performed in the other country and the income is attributable to a fixed base regularly available to the individual in the second country for the purpose of performing the activities.

The proposed treaty generally provides a broader exemption from source-country tax for income from independent personal services than the present treaty. Under the present treaty, an exemption is generally available to a resident of a country only if his or her stay in the other country does not exceed 183 days. The present treaty does not contain the fixed base limitation found in the proposed treaty.

The Technical Explanation provides that it is understood that the term “fixed base” is similar in meaning to the term “permanent establishment” of the proposed treaty. According to the Technical Explanation, the rules of Article 7 (Business Profits) for attributing income and expenses to a permanent establishment are generally relevant for attributing income to a fixed base. In addition, the Technical Explanation states that outside director fees are covered by this article.

The exemption from source-country tax provided in the proposed treaty for independent personal services income is similar to that contained in the U.S. model.

Article 15. Dependent Personal Services

Under the proposed treaty, wages, salaries, and other similar remuneration derived from services performed as an employee in one country (the source country) by a resident of the other country will be 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 consistent with the present treaty, as well as the U.S. and OECD models.

The Technical Explanation provides that in determining the number of days for purposes of the 183-day rule, an individual is considered to be present for any day during which he or she is present in the source country (including part of the day), even if the individual does not work during that day.¹⁸

The proposed treaty provides that compensation derived from employment as a member of the regular complement of a ship or aircraft operated in international traffic may be taxed only in the employee's country of residence.

This article is modified by the provisions with respect to the treatment of pensions (Article 18) and government service (Article 19). In addition, the rules applicable to artistes and athletes (Article 17) apply notwithstanding the rules of this article.

Article 16. Limitation on Benefits

In general

The proposed treaty contains a provision, not found in the present treaty, 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 Austria.

The proposed treaty is intended to limit double taxation caused by the interaction of the tax systems of the United States and Austria 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" and 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.

¹⁸See Rev. Rul. 56-24, 1956-1 C.B. 851.

Summary of proposed treaty provisions

The anti-treaty-shopping article in the proposed treaty provides that a treaty country resident is entitled to treaty benefits in the other country only if it fits into one of several categories or is otherwise approved by that country's competent authority, in the exercise of the latter's discretion. 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.¹⁹ However, the proposed treaty provides opportunities for treaty benefit eligibility which are not provided under the regulation.

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

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

In addition, an item of income that is derived in connection with, or incidental to, an active trade or business conducted in the other country may qualify for treaty benefits under the active business test.

Special rules apply to interest and royalty income derived by an Austrian company in certain "triangular" cases described below.

The MOU provides that the provisions of the proposed treaty, such as those under this article, designed to prevent abusive transactions will not prevent the United States or Austria from applying its internal law "substance over form" rules.

The competent authorities shall, pursuant to the authority provided in accordance with the provisions of Article 25 (Exchange of Information and Administrative Assistance), exchange such information as is necessary for carrying out the provisions of this article and safeguarding the application of their internal laws.

Ownership and base erosion tests

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

To meet the ownership test, more than 50 percent of the beneficial interest in the entity must be owned, directly or indirectly, by persons that qualify as treaty residents under certain tests of the proposed treaty or who are U.S. citizens.²⁰ In the case of a

¹⁹Treas. Reg. sec. 1.884-5.

²⁰For this purpose, a qualified treaty resident is a person who is entitled to benefits under the proposed treaty as an individual resident of Austria or the United States, a public company or public company subsidiary (as described in the discussion of the public company tests below),

company, qualified treaty residents or U.S. citizens must own, directly or indirectly, more than 50 percent of the number of shares of each class of the company's shares.

To meet the base erosion test, not more than 50 percent of the gross income of the entity may be used, directly or indirectly, to meet liabilities (including liabilities for interest or royalties) to persons or entities other than U.S. citizens or certain persons that qualify as treaty residents. This rule 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 treaty.

Public company tests

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

Publicly traded companies

A company that is a resident of Austria or the United States is entitled to treaty benefits, if the principal class of its shares is substantially and regularly traded on one or more recognized stock exchanges. The Technical Explanation provides that the term "principal class of shares" is intended to be interpreted as the class of shares that represents the majority of the voting power and value of the company. When no single class of shares represents the majority of the voting power and value of the company, the term generally means those classes that in the aggregate possess more than 50 percent of the voting power and value of the company. The term "shares" includes depository receipts or trust certificates. In determining voting power, any shares or class of shares that are authorized but not issued shall not be counted; and in mutual agreement between the competent authorities, appropriate weight shall be given to any restrictions or limitations on voting rights of, or entitlement to disproportionately higher participation in, issued shares. Thus, such a company is entitled to the benefits of the treaty regardless of where its actual owners reside or the amount or destination of payments it makes.

Subsidiaries of publicly traded companies

A company that is a resident of Austria or the United States is entitled to treaty benefits if it is at least 90-percent owned, directly or indirectly, by five or fewer companies which are residents of either treaty country, the principal classes of the shares of which are publicly traded as described above, provided that the owner of any

one of the treaty countries or a political subdivision or local authority thereof, or a non-profit organization (as described in the discussion of qualifying organizations below).

remaining portion of the company is an individual resident of Austria or the United States. The Technical Explanation provides that if the ownership of any remaining portion of the company belongs to more than one individual, each such individual must be a resident of either country.

Definitions

The term “recognized stock exchange” includes the NASDAQ System, any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for the purposes of the Securities Exchange Act of 1934, and the Vienna Stock Exchange. The term generally includes any other stock exchange agreed upon by the competent authorities of the two countries. U.S. internal law contains an exception to the definition of a “recognized stock exchange” in the case of a closely held company for purposes of identifying a “qualified resident” eligible for treaty protection from the U.S. branch tax.²¹ The regulation provides that stock in certain closely held companies will not be treated as “regularly traded.” The proposed treaty has no special rule for closely held companies in defining the term “substantial and regular trading.” Consequently, it will be easier for a closely held company to qualify as a resident of the United States or Austria under the proposed treaty than under the U.S. branch tax rules.

The proposed treaty does not define “substantial” and “regular” trading. A definition for “regular” trading can be found in the regulations under Code section 884(e) for purposes of identifying a “qualified resident” eligible for treaty protection from the U.S. branch tax.²²

Non-profit organizations

An entity also will be entitled to benefits under the proposed treaty if it is a not-for-profit organization which, by virtue of that status, generally is exempt from income taxation in its treaty country of residence, provided that more than half the beneficiaries, members, or participants, if any, in the organization are persons that are entitled to benefits under the proposed treaty. The not-for-profit organizations described include, but are not limited to, pension funds and private foundations.

Headquarters companies

A treaty country resident is entitled to all the benefits of the proposed treaty if that person functions as a headquarters company for a multinational corporate group. As set forth in the MOU, a company is considered to be a headquarters company for this purpose only if each of several criteria is satisfied. The person seeking such treatment must provide in its country of residence a substantial portion of the overall supervision and administration of the group, which may include, but cannot be principally, group financing. The person must have, and exercise, independent discretionary authority to carry out these functions. It must be subject to the same income taxation rules in its residence country as other per-

²¹ Treas. Reg. sec. 1.884-5(d)(4)(iii).

²² Treas. Reg. sec. 1.884-5(d)(4).

sons entitled to the benefits of the proposed treaty. The group must consist of corporations resident in, and engaged in an active business in, at least five countries, and the income derived in the treaty country of which the headquarters company is not a resident must be derived in connection with, or be incidental to, those active business activities. The business activities carried on in each of the five countries (or five groupings of countries) must generate at least 10 percent of the gross income of the group. The business activities carried on in any one country (other than the country where the headquarters company is resident) cannot generate 50 percent or more of the gross income of the group. Moreover, no more than 25 percent of the headquarters company's gross income may be derived from the treaty country of which it is not a resident.

Other recent U.S. income tax treaties, such as the treaty with the Netherlands and the treaty with France, also contain a headquarters company provision in the limitation on benefits article.

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 Austria if it is engaged in the active conduct of a trade or business in its residence country, the income derived from the source country is derived in connection with, or is incidental to, that trade or business, and, with respect to income derived in connection with that trade or business, the trade or business is substantial in relation to the activity carried on in the source country which provides the income with respect to which treaty benefits are claimed. According to the Technical Explanation, the test is applied separately to each item of income.

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

The active trade or business rule is consistent with similar tests in recent U.S. treaties, and replaces a more general rule in some other U.S. income tax treaties that preserves benefits if an entity is not used "for a principal purpose of obtaining benefits" under a treaty. However, unlike other treaties, and to some extent like the regulations under Code section 884(e), the proposed treaty (in its text and as elucidated in the MOU) elaborates at length on the conditions under which the active business will, and will not, be considered to be met.

The MOU provides several examples to illustrate the operation of the active trade or business test.

Income derived in connection with a substantial business

The MOU specifies that income is derived in connection with, or is incidental to, 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 resi-

dence country by the income recipient.²³ Alternatively, the income must be produced by assets that are part of the income recipient's business property. Under the U.S. model, 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 by the income recipient. The U.S. model does not contain the proposed treaty's alternative definition for income derived in connection with a trade or business (i.e., income produced by assets that are part of the income recipient's business property).

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

Whether the trade or business of the income recipient is substantial generally is determined by reference to its proportionate share of the trade or business in the source country, the nature of the activities performed, and the relative contributions made to the conduct of the trade or business in both countries.²⁴ The MOU provides a safe harbor for this purpose. Under the safe harbor, the trade or business of the income recipient will be deemed 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. The attributes are assets, gross income, and payroll expense. The level of each such attribute in the active conduct of the trade or business by the income recipient in the residence country, and the level of each such attribute in the trade or business producing the income in the source country, is measured for the prior year. For each separate attribute, the ratio of the residence country level to the source country level is computed.

In general, the safe harbor is satisfied if the average of the three ratios is greater than 10 percent, and each ratio separately is greater than 7.5 percent. If any separate ratio is equal to or less than 7.5 percent for the prior year, the average of the corresponding ratios in the three prior years may be substituted. These safe harbor percentages are similar to those contained in the U.S. model.

²³ Cf. Treas. Reg. sec. 1.884-5(e)(1) and (e)(4). (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 active trade or business conducted by the foreign corporation in its residence country; a business is an integral part if it comprises in principal part complementary and mutually interdependent steps in the production and sale or lease of goods or in the provision of services.)

²⁴ 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).

Income incidental to a trade or business

According to the MOU, income that is incidental to a trade or business is defined in the same manner as income that is derived in connection with a trade or business. Under that definition, income is incidental to 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, or the income is produced by assets that are part of the income recipient's business property. One of the examples contained in the MOU illustrates that income from the short-term investment of the working capital of the residence-country trade or business is treated as "incidental income". Unlike the proposed treaty, the U.S. model defines incidental income separately from income derived in connection with a trade or business. Under the U.S. model definition, income is incidental to a trade or business in the residence country if the production of such income facilitates the conduct of a trade or business in the other country.

Attribution rules

As set forth in the MOU, the active business test takes into account the extent to which the person seeking treaty benefits either is itself engaged in business or is deemed to be so engaged through the activities of related persons. The MOU provides that under the proposed treaty, a treaty country resident is deemed to be engaged in the active conduct of a trade or business in its residence country (and is considered to carry on the proportionate share of such trade or business) if it is a partner in a partnership that is so engaged, or if it owns, either alone or as a member of a group of five or fewer persons that are qualified persons or residents of an "identified state," a controlling beneficial interest in a person that is engaged in the active conduct of a trade or business in the resident country of such owner.²⁵

A company resident in a treaty country is also deemed to be engaged in the active conduct of a trade or business in its residence country if it is a member of a group of companies that form or could form a consolidated group for tax purposes in the residence country and the group is engaged in the active conduct of a trade or business in that country.²⁶ A similar principle applies if a treaty country resident is under the common control with another person that is so engaged, provided that the control is held by five or fewer persons that are qualified persons or residents of an identified state.

Finally, the activities of an owner of a treaty country resident may be attributed to such resident. Attribution to a treaty country resident applies if a controlling beneficial interest in the treaty country resident is held by a single person engaged in the active conduct of a trade or business in that same country. Attribution also applies if a controlling beneficial interest in the treaty country resident is held by a group of five or fewer persons, each of which

²⁵ An "identified state" means any third country, identified by agreement of the competent authorities, which has effective provisions for the exchange of information with the residence country of the person being tested under these rules.

²⁶ This rule is applied without regard to the residence of such companies.

is engaged in activity in that country which is a component part of or directly related to the trade or business in that country.

Grant of treaty benefits by the competent authority

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 treaty. Under this provision, such a person may be granted treaty benefits if the competent authority of the source country so determines. The MOU provides that in making this determination, the competent authority will take into account as its guideline whether the establishment, acquisition, or maintenance of the person, or the conduct of its operations, has or had as its principal purpose the obtaining of benefits under the proposed treaty. The competent authority of the source country will consult with the competent authority of the other country before denying the benefits of the treaty under this rule.

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

The MOU provides that in determining whether the establishment, acquisition, or maintenance of a corporation resident in one of the States has or had as its principal purpose the obtaining of benefits under the proposed treaty, the competent authorities may consider the following factors (among others):

- (1) the existence of a clear business purpose for the structure and location of the income earning entity in question;
- (2) the conduct of an active trade or business (as opposed to a mere investment activity) by such entity;
- (3) a valid business nexus between that entity and the activity giving rise to the income; and
- (4) the extent to which an entity which is a corporation would be entitled to treaty benefits comparable to those afforded by the proposed treaty if it had been incorporated in the country of residence of the majority of its shareholders.

The MOU contains an example that illustrates the application of these principles.

The MOU provides that Austria’s membership in the EU is a factor in the determination of eligibility for treaty benefits of an Austrian company with significant other EU member ownership or with significant business activities carried on in EU countries. Similar principles apply with respect to the special relationship between the United States, Canada, and Mexico under the North American Free Trade Agreement.

The MOU provides that if the United States and Austria determine that it is desirable to amend Article 16 of the proposed treaty

to reflect the closer relationship between Austria and its EU partners, the negotiators will promptly negotiate a Protocol in this regard.

Triangular cases

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

This article provides for an exception to the general rule in Articles 11 and 12 of the proposed treaty that eliminate or reduce the U.S. tax on interest and royalties. If the exception applies, the United States may tax the interest or royalty in accordance with its internal law (i.e., the United States generally may impose a 30-percent withholding tax on payments made to an Austrian resident).

In order for this U.S. withholding tax to be imposed, two conditions must be met. First, the interest or royalty must be derived by an Austrian enterprise and must be attributable to a permanent establishment of that enterprise in a third jurisdiction. Second, combined Austrian and third country tax on the profits of the permanent establishment must be levied at an effective rate which is less than 60 percent of the general rate of company tax applicable in Austria.

The special rule generally does not apply to interest income derived in connection with, or incidental to, an active 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), royalties that are received as compensation for the use of, or the right to use, intangible property produced or developed by the permanent establishment, or if the income is subject to taxation by the United States under the subpart F controlled foreign corporation rules.

Article 17. Artistes and Athletes

Like the U.S. and OECD models, the proposed treaty contains rules that apply to the taxation of income earned by entertainers (such as theater, motion picture, radio, or television “artistes,” or musicians) and athletes. 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 athletes from using the treaty to avoid paying any tax on their income earned in one of the countries. However, an artiste or athlete not subject to host country tax under the provisions of this article may still be taxable by that country under the rules of Article 14 or 15.

Under this article of the proposed treaty, one country may tax an entertainer or athlete who is a resident of the other country on the income from his or her personal services as such in the first country during any year in which the gross receipts derived from such activities, including reimbursed expenses, exceed \$20,000 or its Austrian shillings equivalent. Thus, if an Austrian entertainer maintained no fixed base in the United States and performed (as an independent contractor) for one day of a taxable year in the United States for gross receipts of \$2,000, the United States could not tax that income. If, however, that entertainer's gross receipts were \$30,000, the full \$30,000 (less appropriate deductions) would be subject to U.S. tax. This provision does not bar the country of residence from also taxing that income (subject to a foreign tax credit). (See Article 22 (Relief from Double Taxation), below.) The Technical Explanation clarifies that because it is not possible to know whether the \$20,000 (or the Austrian shillings equivalent) is exceeded until the end of the year, the source country may subject all payments to an artiste or athlete to withholding and then refund any excess amount withheld.

The Technical Explanation provides that in determining whether income is governed by this article, the controlling factor is whether the income in question is predominately attributable to the performance itself or other activities or property rights. In the case where an individual functions as a performer and non-performer, and the role in one of the capacities is negligible, the predominant character of the individual's activities should control the characterization of those activities. If the roles are not negligible, there should be an apportionment between the performance related compensation and the other compensation.²⁷

The proposed treaty provides a standard provision that is intended to address potential abuses. Under this provision, where income in respect of activities exercised by an entertainer or athlete in his or her capacity as such accrues not to the entertainer or athlete, but to another person, that income may be taxed by the country in which the activities are exercised, unless it is established that neither the entertainer or athlete 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, independent personal service and dependent service articles (Articles 7, 14 and 15).) This provision prevents certain performers and athletes from avoiding tax in the country in which they perform by, for example, routing the compensation for their services through a third entity such as a personal holding company or a trust located in a country that would not tax the income.

In cases where payments are made to a person other than the entertainer or athlete who exercised the activities, but that do not involve routing payments to an entity to avoid source-country tax as described above, the proposed treaty provides that such payments may be subject to source-country tax. Upon request of that person, the withholding tax may be refunded to the extent the

²⁷ See paragraph 4 of the Commentaries to Article 17 of the OECD model.

amount exceeds the tax liability of the entertainer or the athlete. The Technical Explanation indicates that the refund claims must be accompanied by proper documentation. An example in the Technical Explanation illustrates that such a case may arise when a payment is made to an entertainer through a third-country promotor.

The MOU clarifies that entities operating an orchestra generally are not subject to the provisions of this article. On the other hand, individual members of an orchestra may be subject to the provisions of this article if their annual remuneration received for the performance in the source country exceeds \$20,000. In computing whether an individual satisfies this threshold, the MOU states that a monthly salary is allocated to the days spent in the source country; however, the entire amount of a performance-related global payment (e.g., a payment consisting of compensation for performance in Austria and for preparation outside of Austria) is taken into account.

The foregoing provisions are generally similar to provisions in the U.S. and OECD models dealing with entertainers and athletes.

Article 18. Pensions

This article contains rules applicable to the tax treatment of private pensions and annuities, social security benefits, alimony and child support payments, and cross-border pension contributions.

Under the proposed treaty, as in the present treaty, pensions and other similar remuneration beneficially derived by a resident of either country in consideration of past employment generally are subject to tax only in the recipient's country of residence. This rule is subject to the provisions of Article 19 (Government Service). Thus, it generally does not apply, for example, in the case of pensions paid to a resident of one country attributable to services performed for government entities of the other. The Technical Explanation provides that this provision covers amounts paid by all private retirement plans and arrangements in consideration of past employment, regardless of whether they are considered qualified plans under the Code.

Social Security payments and other public pensions²⁸ paid by one country to an individual who is a resident of the other country or to a U.S. citizen will be taxable only by the paying country. (This rule also is subject to the provisions of Article 19 (Government Service).) This rule, which is not subject to the saving clause, exempts U.S. citizens and residents from U.S. tax on Austrian social security payments. Under this rule, only the United States may tax U.S. social security payments to residents of Austria. The rule thus safeguards the United States' right under the Social Security Amendments of 1983 to tax a portion of U.S. social security benefits received by nonresident individuals, while protecting any such individuals residing in Austria from double taxation.

The proposed treaty provides that annuities may be taxed only in the country of residence of the person who beneficially owns

²⁸ According to the MOU, the term "other public pensions" is intended to refer to U.S. tier 1 Railroad Retirement benefits. In addition, the term "social security payments" is not restricted to old age pensions but also refers to other types of social security benefits such as payments to compensate work-related diseases or accidents.

them. An annuity is defined as a stated sum payable periodically at stated times during a specified number of years, under an obligation to make the payments in return for adequate and full consideration.

Unlike the present treaty, the proposed treaty provides for the treatment of alimony and child support payments. The proposed treaty grants exclusive taxing rights with respect to alimony to the treaty country of residence of the payor. This rule is different from the U.S. model, which provides that the recipient's country of residence has the exclusive taxing rights with respect to alimony payments. The term "alimony" as used in the article of the proposed treaty means periodic payments made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support. This rule is not subject to the saving clause; thus, alimony payments from an Austrian resident to a U.S. resident or citizen are taxable only in Austria.

Under the proposed treaty, child support payments (made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support) are exempt from tax by both countries. This rule is the same as the rule in the U.S. model.

The proposed treaty deals with the taxation of contributions borne by an individual who renders dependent personal services in one country (the host country) to a pension plan established in, and recognized for tax purposes, in the other country. In general, under the proposed treaty, in determining the individual's taxable income, the host country may be required to treat such contributions in the same way and subject them to the same conditions and limitations as contributions made to a pension plan established in the host country. Such treatment is provided only if the employee was not a resident of the host country and contributed to the pension plan immediately before exercising employment in the host country. In addition, the competent authority of the first country must agree that the pension plan corresponds to a pension plan recognized for tax purposes by that country.

Article 19. Government Service

The proposed treaty generally exempts the wages of employees of one country from tax by the other country. Under the proposed treaty, remuneration, including pensions, annuities or similar benefits, paid by a country or one of its political subdivisions or local authorities to a citizen of such country for services rendered as an employee of that country (or subdivision or authority) generally is taxable only in that country.

The proposed treaty states that the above rule also applies to remuneration paid to the Austrian Foreign Trade Representatives of the Austrian Federal Economic Chamber and to the staff members of the Austrian Foreign Trade Offices who are Austrian citizens to the extent they are discharging governmental functions in the United States. The MOU provides that employees of a government entity (such as an Embassy or Consulate) engaging in activities such as cleaning or driving are considered to be discharging governmental functions and, thus, are covered under this article.

If a country or one of its political subdivisions or local authorities is carrying on a business (as opposed to functions of a govern-

mental nature), the provisions of Articles 14 (Independent Personal Services), 15 (Dependent Personal Services), 17 (Artistes and Athletes), and 18 (Pensions) will apply to remuneration and pensions for services rendered in connection with such business.

This article is an exception to the saving clause, pursuant to Article 1, paragraph 5(b) of the proposed treaty. Consequently, the saving clause does not apply to benefits conferred by this article with respect to an individual who is not a citizen of the country conferring such benefits, and, in the case where the United States is the conferring country, such individual is not a green-card holder. Thus, for example, the United States would not tax the compensation of an Austrian citizen who is not a U.S. green-card holder but who resides in the United States to perform services for the Austrian Government.

Article 20. Students and Trainees

Like Article XII of the present treaty, the proposed treaty provides host country tax exemptions for a student, apprentice, or trainee, with respect to certain remittances from abroad for the purpose of the individual's maintenance, education or training. The U.S. and OECD models also provide for some host-country exemptions for students and trainees; the proposed treaty and the U.S. model differ from the OECD model by providing a time limit for such exemption.

Under the proposed treaty, an individual temporarily present in a treaty country for full-time education at a recognized educational institution, or for full-time training, and who, immediately before visiting the host country, is a resident of the other treaty country, is exempt from host country tax on certain payments he or she receives for a period of three years from the date the individual first arrives in the host country for the purpose of his or her training. Where this rule applies, the host country may not tax remittances from abroad for the purpose of maintenance, education, or training. The Technical Explanation provides that an individual who visits the host country to obtain business training and who also receives a salary from his or her employer for providing services would not be considered a trainee and would not be entitled to the benefits of this article.

The present treaty exempts from host country tax a non-profit sector grant, allowance, or award paid to a recipient of the other country. In addition, remuneration paid to a professor or teacher temporarily visiting the other country is also exempted from host country taxation. The proposed treaty does not contain these exemptions.

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 with respect to an individual who is not a citizen of the country conferring such benefits, and, in the case where the United States is the conferring country, such individual is not a green-card holder. Thus, for example, an Austrian citizen who is not a U.S. green-card holder and who is residing in the United States for the purpose of full-time education would be entitled to the benefit of this article.

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 Austria. This article is substantially identical 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 derived by residents of either country will be 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 Austrian residents will continue to be taxable by the United States on their third-country income, with a foreign tax credit provided for income taxes paid to Austria (see discussion in connection with Article 22 (Relief From Double Taxation), below).

The general rule just stated does not apply to income (other than income from real property (as defined in Article 6)) if the recipient of the income is a resident of one country and carries on business in the other country through a permanent establishment or performs services from a fixed base, and property with respect to which the income is paid is effectively connected with the permanent establishment or fixed base. In such a case, the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, will apply. 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 Austria generally would be taxable by the United States under Article 7 (Business Profits), even if the income was sourced in a third country.

The prohibition on taxation by the country other than the residence country does apply, however, to income from real property that such country is not given permission to tax under Article 6. The Technical Explanation provides that even if real property is part of the property of a permanent establishment or fixed base in a treaty country, that country may not tax income from the property if neither the situs of the property nor the residence of the owner of the property is in that country. Thus, for example, if an Austrian resident derives income from real property located outside the United States that is effectively connected with the resident's permanent establishment or fixed base in the United States, only Austria may tax such income.

Article 22. Relief from Double Taxation

U.S. internal law

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

this rule, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid for the year the dividend is received.

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

Foreign tax credits generally cannot exceed 90 percent of the pre-foreign tax credit alternative minimum tax (determined without regard to the net operating loss deduction). However, no such limitation will be imposed on a corporation if more than 50 percent of its stock is owned by U.S. persons, all of its operations are in one foreign country with which the United States has an income tax treaty with information exchange provisions, and certain other requirements are met. The 90-percent alternative minimum tax foreign tax credit limitation, enacted in 1986, overrode contrary provisions of then-existing treaties.

Austrian internal law

Austria unilaterally mitigates double taxation in several ways. First, the general rule of Austrian law that mitigates double corporate-level taxation—the so-called “participation exemption”—generally exempts a taxable Austrian company from corporate income tax on dividends derived in connection with a “participation” in another entity, including in many cases a foreign company. A participation may be deemed to exist on the basis of a 25-percent or more shareholding in the entity. Where the entity is foreign, the entity must be subject to certain types of foreign tax law in order for the participation exemption to apply.

Certain other types of foreign income of an Austrian resident may be unilaterally exempt from Austrian tax on a pro rata basis. That is, Austrian tax on worldwide income is reduced in the same proportion that exempt foreign income bears to worldwide income. This is also referred to as “exemption with progression,” in light of the fact that all worldwide income is included in the tax base for purposes of determining the marginal rate of Austrian tax that applies. Finally, foreign withholding taxes on certain dividends, interest, and royalties are in some limited cases (generally inapplicable to U.S.-source items) unilaterally creditable against Austrian tax.

Proposed treaty rules

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

Part of the double tax problem is dealt with in other articles of the proposed treaty that limit the right of a source country to tax income. This article provides further relief where both Austria 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 country of citizenship or residence waives its overriding taxing jurisdiction to the extent that this article applies.

Under the present treaty, the United States, subject to the provisions of sections 901 through 905 of the Code, grants a foreign tax credit for the Austrian taxes specified in Article I. Austria likewise grants a credit against its tax for the amount of United States taxes specified in Article I with respect to income received from sources within the United States by its residents or corporations. However, the amount allowed as a credit is not in any case permitted to exceed the Austrian tax imposed on the income from sources within the United States. The proposed treaty modifies this system of the present treaty. The modifications include amending the rules applicable to U.S. citizens resident in Austria.

Proposed treaty limitations on U.S. internal law

The proposed treaty generally provides that the United States will allow a citizen or resident a foreign tax credit for the income taxes imposed by Austria. The proposed treaty also requires the United States to allow the deemed-paid credit, with respect to Austrian income taxes, to any U.S. corporate shareholder of an Austrian company that receives dividends from such company if the U.S. company owns 10 percent or more of the voting stock of the Austrian 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 provision). The MOU clarifies that this requirement refers to the laws in effect as of the date of entry of the proposed treaty, as they may be subsequently amended. The MOU provides that it is understood that, the 90-percent alternative minimum tax foreign tax credit limitation is consistent with the general U.S. commitment to provide a foreign tax credit. The MOU illustrates the calculation of the deemed-paid foreign tax credit and the dividend gross-up under U.S. tax principles.

Austrian taxes covered by the proposed treaty (Article 2 (Taxes Covered)) are to be considered income taxes for purposes of the U.S. foreign tax credit rules.

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

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

(2) Reduce the tentative Austrian 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 an Austrian 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 Austria as computed in step (2) (i.e., after Austria allowed the credit for U.S. taxes). The proposed treaty recharacterizes the income that is subject to Austrian 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 U.S. citizen who is an Austrian resident with respect to an item of income should not be less than the tax that would be paid if the individual were not a U.S. citizen.

The foregoing provisions are similar to those found in many U.S. income tax treaties.

Proposed treaty limitations on Austrian internal law

In general, the proposed treaty requires Austria to continue to employ its "exemption with progression" method with respect to most U.S. income, as it does under the present treaty and internal Austrian law. As explained above, under the exemption with progression method the income, while exempt from tax, is taken into the tax base for purposes of determining the proportion by which Austrian tax is reduced.

In addition, Austria also is required to permit an Austrian resident to claim a foreign tax credit for taxes paid to the United States in accordance with the rules of the proposed treaty. However, the amount of the credit shall not exceed the Austrian tax attributable to the income that may be taxed by the United States. For this purpose, the amount of U.S. branch profits tax (paragraph 6 of Article 10) is deemed to be attributable to the taxable income derived by the U.S. permanent establishment of an Austrian enterprise in the year that the tax is levied.

Article 23. Non-Discrimination

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

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

a resident of the United States and an Austrian national who is not a resident of the United States are not deemed to be in the same circumstances for U.S. tax purposes.

Under the proposed treaty, neither country may tax a permanent establishment of an enterprise of the other country less favorably than it taxes its own enterprise carrying on the same activities. Consistent with the U.S. and OECD models, however, a country is not obligated to grant residents of the other country any personal allowances, reliefs, or reductions for tax purposes granted to its own residents on account of civil status or family responsibilities. Under internal Austrian law, an Austrian enterprise may carry forward its losses for seven years to offset other income of that enterprise. The MOU extends this loss carryforward provision to losses incurred by an Austrian permanent establishment of a U.S. corporation.

In a provision not contained in the present treaty, each country is required (subject to the arm's-length pricing rules of Articles 9 (Associated Enterprises), 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 indicates that 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 rule of nondiscrimination 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. The nondiscrimination provisions do not prevent the imposition of the U.S. branch profits tax.

U.S. internal law generally treats a corporation that distributes property in a 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.²⁹ The MOU states that the application

²⁹See Notice 87-66, 1987-2 C.B. 376.

of this rule is consistent with the nondiscrimination article of the proposed treaty.

U.S. internal law permits certain 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 MOU confirms that the S corporation provisions, including the rule that prevents a nonresident alien from being a shareholder of an S corporation, are not in conflict with the nondiscrimination provisions of the proposed treaty.

U.S. internal law generally requires a partnership that engages in a U.S. trade or business to pay a withholding tax attributable to a foreign partner's share of the effectively-connected income of the partnership. The withholding tax is not the final liability of the partner, but is a prepayment of tax which will be refunded to the 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 MOU provides that it is understood that the withholding tax is a reasonable collection mechanism, and it is not in conflict with the nondiscrimination provisions of the proposed treaty.

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

Article 24. 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 Austria 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 of taxing jurisdiction by the country of citizenship or residence.

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

The competent authorities of the countries are to endeavor to resolve by mutual agreement any difficulties or doubts arising as to

the interpretation or application of the treaty. They may also consult together for the elimination of double taxation in cases not provided for in the treaty.

The proposed treaty makes express provision for the competent authorities to mutually agree on the attribution and allocation of income, deductions, credits, or allowances, the characterization of particular items of income, the determination of the country in which an item of income arises, the common meaning of a term and the elimination of double taxation in cases not provided for in the treaty. The proposed treaty does not provide, as does the U.S. model, that the competent authorities may agree on the same characterization of persons; advance pricing agreements; and the application of penalties, fines, and interest under internal law and increases (where appropriate in light of economic or monetary developments) in the dollar thresholds in provisions such as the artistes and athletes article and the students and trainees provisions.

The proposed treaty authorizes the competent authorities to communicate with each other directly for purposes of reaching an agreement in the sense of this mutual agreement article. This provision makes clear that it is not necessary to go through diplomatic channels in order to discuss problems arising in the application of the treaty. It also removes any doubt as to restrictions that might otherwise arise by reason of the confidentiality rules of the United States or Austria. The competent authorities shall consult together with a view to developing a commonly agreed application of the provisions of the proposed treaty, including the rules of Article 16 (Limitation on Benefits). The competent authorities are authorized to prescribe regulations to carry out the purposes of the proposed treaty.

The MOU clarifies that the mutual agreement procedure is not intended to create new treaty law but is intended to provide the possibility for the two countries to find an agreed position in their interpretation of the provisions of the proposed treaty.

Article 25. 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 tax laws of the two countries provided that taxation under those domestic laws is not contrary to the treaty. The carrying out of the provisions of the two countries concerning taxes includes "penal investigations" regarding fiscal offenses relating to taxes. According to the MOU, the term "penal investigations" applies to proceedings carried out by either judicial or administrative bodies, such as the commencement of a criminal investigation by the Criminal Investigation Division of the IRS. According to the Technical Explanation, it is understood that a U.S. penal investigation forms a basis for disclosure under the Austrian bank secrecy laws and practices.

Any information exchanged is treated as secret in the same manner as information obtained under the domestic laws of the country receiving the information. The exchanged information may be disclosed only to persons or authorities (including courts and adminis-

trative bodies) involved in assessment, collection, administration, enforcement, prosecution or determination of appeals with respect to the taxes covered by this article. The information exchanged may be used only such purposes.³⁰ Exchanged information generally may be disclosed in public court proceedings or in judicial decisions.

The MOU provides that the appropriate committees of the U.S. Congress and the U.S. General Accounting Office shall be afforded access to information for use in the performance of their role in overseeing the administration of U.S. tax laws.³¹ The MOU also provides that such disclosure is permitted (with respect to Austria) to the Accounting Court (Rechnungshof) and the Committees of Parliament as is necessary to carry out their oversight responsibilities.

Under the proposed treaty, information may be exchanged spontaneously or upon request and the competent authorities may agree on information which shall be furnished on a regular basis. The Technical Explanation states that the exchange of information in connection with simultaneous examinations is contemplated. In addition, the Technical Explanation permits the presence of tax examiners within the other country for purposes of conducting tax examinations, including interviewing taxpayers (with the consent of such taxpayers). In addition, the MOU provides that a request for information cannot be rejected by the requested state merely because the request was made for the purposes of pending judicial proceedings.

As is true under the present treaty and the U.S. and OECD models, under the proposed treaty a country is not required to carry 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 discloses any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which is contrary to public policy. The MOU provides, on the basis of paragraph 19 of the OECD Commentary on Article 26 of the OECD model, provisions on bank secrecy do not constitute a professional, trade, business, industrial, or commercial secret. Consequently, according to the Technical Explanation, Austrian bank account information may be exchanged under this article upon commencement of a U.S. penal investigation.

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 its tax were at issue. Where specifically requested by the competent authority of one country, the competent authority of the other country shall endeavor to provide the information in the form requested. Specifically, the competent authority of the other country will endeavor to pro-

³⁰ 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.

³¹ The MOU clarifies that this rule intends that the Senate Committee on Finance, the House Committee on Ways and Means and the Joint Committee on Taxation, as well as the U.S. General Accounting Office, will have access to all information received under the proposed treaty under the above-described conditions.

vide depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, accounts, and writings) to the same extent that they can be obtained by such other competent authority under the laws and administrative practices of such other country.

The proposed treaty provides that the tax authorities may deliver documents to persons in the other country by using postal services. Each country shall determine in accordance with its domestic law the legal efficacy or sufficiency of the documents that are so delivered.

The information exchange provisions of the proposed treaty apply to assistance carried out under penal investigation procedures. Accordingly, for an exchange of information in connection with a U.S. penal proceeding (as interpreted in the MOU), Austria has agreed to use its penal investigation procedures. However, the proposed treaty does not cover arrests of persons.

The exchange of information provisions are not restricted by Article 1 (Personal Scope). Therefore, third-country residents are covered. For example, the Technical Explanation provides that the United States may request information with respect to an Austrian bank account of a third-country resident under the proposed treaty. In addition, like the U.S. model, the exchange of information article (except for the assistance in collection provision) is not restricted by Article 2 (Taxes Covered).

Assistance in collection

The proposed treaty generally provides that the countries are to undertake to assist and support each other in collecting the taxes enumerated in Article 2 of the proposed treaty to the extent necessary to ensure that treaty benefits are enjoyed only by persons entitled to those benefits under the proposed treaty. The MOU provides that the assistance extends to interest but not fines or other penalties.

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

Under the proposed treaty, the certified document shall be rendered enforceable under the laws of the requested country. The proposed treaty provides that where Austria is the country requesting assistance, such document must be rendered enforceable by the Regional Finance Directorates (Finanzlandesdirektionen).

Under the proposed treaty, an accepted request shall be collected by the accepting country as though the claim were that country’s own revenue claim that has been finally determined. However, the claim will not have, in the accepting country, any priority accorded

to the revenue claims of that country (e.g., in the case of a bankruptcy). In the event that judicial execution is necessary, the proposed treaty provides that a request from Austria shall be requested by the Finanzprokuratur or by the finance office delegated to act on his behalf. The proposed treaty provides that appeals concerning the existence or the amount of the debt shall lie only to the competent tribunal of the requesting country.

Similar to the U.S. model, the collection provision does not impose on either country the obligation to carry out administrative measures of a different nature from those used in the collection of its own taxes, or that is contrary to its sovereignty, security, public policy or essential interest. According to the MOU, a country that has been requested to recover a tax on behalf of the other country may deny the request by invoking this "essential interest" clause and claim that the tax in question is not levied in accordance with the provisions of the proposed treaty.

The MOU clarifies that the requested country shall be obligated to obtain the requested information according to its procedures at the time of the request (and not its procedures at the time the treaty enters into force). In addition, the MOU clarifies that the exchange of information and collection provisions are not confined to taxes levied, or information coming into existence, after the proposed treaty becomes effective.

Article 26. Diplomatic Agents and Consular Officers

The proposed treaty contains the rule found in other U.S. tax treaties that its provisions are not to affect the privileges of diplomatic agents or consular officials under the general rules of international law or the provisions of special agreements. Accordingly, the proposed treaty will not defeat the exemption from tax which a host country may grant to the salary of diplomatic officials of the other country. The saving clause does not apply in full to this article, so that, for example, U.S. diplomats who are considered Austrian residents generally may be protected from Austrian tax.

Article 27. Application of the Convention

As a matter of internal law, the United States generally implements treaty reductions in taxes subject to withholding by reducing the amounts of tax withheld at the source. An alternative that the United States views as permissible under treaties is the refund of amounts withheld at the statutory rates. The proposed treaty contains express language confirming the validity of the latter method under this treaty. It provides that if a treaty country taxes an item by withholding at source, then the right to require withholding at the statutory rate is not affected by the treaty. The proposed treaty requires that the tax be refunded on application to the extent of the treaty reduction in accordance with the applicable procedures of the country under whose laws the withholding is made.

Article 28. Entry Into Force

The proposed treaty will enter into force on the first day of the second month following the exchange of instruments of ratification. The provisions of the proposed treaty generally take effect for taxable years and periods beginning on or after the first day of Janu-

ary in the year following the date of entry into force. In the case of taxes payable at source, the proposed treaty generally takes effect for payments made on or after the first day of the second month following the date the treaty enters into force (i.e., the first day of the fourth month following the exchange of instrument of ratification). The MOU clarifies that the provisions of the exchange of information and administrative assistance article (Article 25) are not confined to taxes levied, or to information coming into existence after the date the proposed treaty enters into force.

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

Article 29. Termination

The proposed treaty will continue in force until terminated by a treaty country. Either country may terminate it at any time after five years from the date of its entry into force by giving at least six months prior written notice through diplomatic channels. A termination will be effective for taxable years and periods beginning after the end of the calendar year in which the notice has been given. With respect to taxes payable at source, a termination will be effective for payments made after the end of the calendar year in which the notice has been 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 Austria for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Vienna on May 31, 1996 (Treaty Doc. 104-31), subject to the understanding of subsection (a), the declarations of subsection (b), and the proviso of subsection (c).

(a) UNDERSTANDING.—The Senate's advice and consent is subject to the following understanding, which shall be included in the instrument of ratification, and shall be binding on the President:

(1) OECD COMMENTARY.—Provisions of the Convention that correspond to provisions of the Organization for Economic Cooperation and Development (OECD) Model Tax Convention on Income and on Capital generally shall be expected to have the same meaning as expressed in the OECD Commentary thereon. The United States understands, however, that the foregoing will not apply with respect to any reservations or observations it enters to the OECD Model or its Commentary and that it may enter such a reservation or observation at any time.

(b) DECLARATIONS.—The Senate's advice and consent is subject to the following two declarations, which shall be binding on the President:

(1) REAL ESTATE INVESTMENT TRUSTS.—The United States shall use its best efforts to negotiate with the Republic of Austria a protocol amending the Convention to provide for the application of subparagraph (b) of paragraph 2 of Article 10 of the Convention to dividends paid by a Real Estate Investment Trust in cases where (i) the beneficial owner of the dividends beneficially holds an interest of 5 percent or less in each class of the stock of the Real Estate Investment Trust and the dividends are paid with respect to a class of stock of the Real Estate Investment Trust that is publicly traded or (ii) the beneficial owner of the dividends beneficially holds an interest of 10 percent or less in the Real Estate Investment Trust and the Real Estate Investment Trust is diversified.

(2) 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.

(c) PROVISIO.—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.