[JOINT COMMITTEE PRINT]

EXPLANATION OF PROPOSED INCOME TAX TREATY BETWEEN THE UNITED STATES AND THE DEMOCRATIC SOCIALIST REPUBLIC OF SRI LANKA

SCHEDULED FOR A HEARING

BEFORE THE

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UNITED STATES SENATE

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, describes the proposed income tax treaty between the United States and the Democratic Socialist Republic of Sri Lanka, as supplemented by a protocol (the "proposed protocol") and an exchange of diplomatic notes (the "notes"). The proposed treaty was signed on March 14, 1985. The proposed protocol and notes were signed on September 20, 2002. Unless otherwise specified, the proposed treaty, the proposed protocol, and the notes are hereinafter referred to collectively as the "proposed treaty." The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed treaty for February 25, 2004.[2]

Part I of the pamphlet provides a summary of the proposed treaty. Part II provides a brief overview of U.S. tax laws relating to international trade and investment and of U.S. income tax treaties in general. Part III contains a brief overview of Sri Lankan tax laws. Part IV contains an article-by-article explanation of the proposed treaty. Part V contains a discussion of issues raised by the proposed treaty.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and the Democratic Socialist Republic of Sri Lanka* (JCS–2–04), February 19, 2004.

[2] For the text of the proposed treaty, *see* Senate Treaty Doc. 108–9.

I. SUMMARY

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

As in other U.S. tax treaties, these objectives principally are achieved through each country's agreement to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other country. For example, the proposed treaty contains provisions under which each country generally agrees not to tax business income derived from sources within that country by residents of the other country unless the business activities in the taxing country are substantial enough to constitute a permanent establishment (Article 7). 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 (Article s 15, 16, and 18). The proposed treaty provides that dividends, interest, royalties, and certain capital gains derived by a resident of either country from sources within the other country generally may be taxed by both countries (Article s 10, 11, 12, and 13); however, the rate of tax that the source country may impose on a resident of the other country on dividends, interest, and royalties may be limited by the proposed treaty (Article s 10, 11, and 12).

In situations in which 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 potential double taxation through the allowance by the country of residence of a tax credit for certain foreign taxes paid to the other country (Article 24).

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

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

The United States and Sri Lanka do not have an income tax treaty currently in force. The proposed treaty is similar to other recent U.S. income tax treaties, the 1996 U.S. model income tax treaty ("U.S. model"), the 1992 model income tax treaty of the Organization for Economic Cooperation and Development, as updated ("OECD model"), and the 1980 United Nations Model Double Taxation Convention Between Developed and Developing Countries, as amended in 2001 ("U.N. model"). However, the proposed treaty contains certain substantive deviations from these treaties and models.

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

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

A. U.S. Tax Rules

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

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

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

Specific statutory exemptions from the 30-percent withholding tax are provided. For example, certain original issue discount and certain interest on deposits with banks or savings institutions are exempt from the 30-percent withholding tax. An exemption also is provided for certain interest paid on portfolio debt obligations. In

addition, income of a foreign government or international organization from investments in U.S. securities is exempt from U.S. tax.

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

Rules are provided for the determination of the source of income. For example, interest and dividends paid by a U.S. citizen or resident or by a U.S. corporation generally are considered U.S.-source income. Conversely, dividends and interest paid by a foreign corporation generally are treated as foreign-source income. Special rules apply to treat as foreign-source income (in whole or in part) interest paid by certain U.S. corporations with foreign businesses and to treat as U.S.-source income (in whole or in part) dividends paid by certain foreign corporations with U.S. businesses. Rents and royalties paid for the use of property in the United States are considered U.S.-source income.

Because the United States taxes U.S. citizens, residents, and corporations on their worldwide income, double taxation of income can arise when income earned abroad by a U.S. person is taxed by the country in which the income is earned and also by the United States. The United States seeks to mitigate this double taxation generally by allowing U.S. persons to credit foreign income taxes paid against the U.S. tax imposed on their foreign-source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax liability on U.S.-source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign-source income. The foreign tax credit limitation generally is computed on a worldwide basis (as opposed to a "per-country" basis). The limitation is applied separately for certain classifications of income. In addition, a special limitation applies to the credit for foreign taxes imposed on foreign oil and gas extraction income.

For foreign tax credit purposes, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation (or is otherwise required to include in its income earnings of the foreign corporation) is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid and its foreign tax credit limitation calculations for the year in which the dividend is received.

B. U.S. Tax Treaties

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. Another related objective of U.S. tax treaties is the removal of the barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal. To a large extent, the treaty provisions designed to carry out these objectives supplement U.S. tax law provisions having the same objectives; treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty partner.

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

Treaties define the term "resident" so that an individual or corporation generally will not be subject to tax as a resident by both the countries. Treaties generally provide that neither country will tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a permanent establishment or fixed base in that jurisdiction. Treaties also contain commercial visitation exemptions under which individual residents of one country performing personal services in the other will not be required to pay tax in that other country unless their contacts exceed certain specified minimums (e.g., presence for a set number of days or earnings in excess of a specified amount). Treaties address passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country either by providing that such income is taxed only in the recipient's country of residence or by reducing the rate of the source country's withholding tax imposed on such income. In this regard, the United States agrees in its tax treaties to reduce its 30-percent withholding tax (or, in the case of some income, to eliminate it entirely) in return for reciprocal treatment by its treaty partner.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect. The United States also provides in its treaties that it will allow a credit against U.S. tax for income taxes paid to the treaty partners, subject to the various limitations of U.S. law.

The objective of preventing tax avoidance and evasion generally is accomplished in treaties by the agreement of each country to exchange tax-related information. Treaties generally provide for the exchange of information between the tax authorities of the two countries when such information is necessary for carrying out provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information that is not obtainable under its laws or in the normal course of its administration or that would reveal trade secrets or other information the disclosure of which would be contrary to public policy. The Internal Revenue Service (the "IRS"), and the treaty partner's tax authorities, also can request specific tax information from a treaty partner. This can include information to be used in a criminal investigation or prosecution.

Administrative cooperation between countries is enhanced further under treaties by the inclusion of a "competent authority" mechanism to resolve double taxation problems arising in individual cases and, more generally, to facilitate consultation between tax officials of the two governments.

Treaties generally provide that neither country may subject nationals of the other country (or permanent establishments of enterprises of the other country) to taxation more burdensome than that it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither treaty country may discriminate against enterprises owned by residents of the other country.

At times, residents of countries that do not have income tax treaties with the United States attempt to use a treaty between the United States and another country to avoid U.S. tax. To prevent third-country residents from obtaining treaty benefits intended for treaty country residents only, treaties generally contain an "anti-treaty-shopping" provision that is designed to limit treaty benefits to bona fide residents of the two countries.

III. OVERVIEW OF SRI LANKAN TAX LAW[3]

A. National Income Taxes

Overview

Sri Lanka imposes income tax on net income at the national level. The types of income subject to tax are specifically enumerated under the law and include income from a trade, business, profession or vocation (business income), income from property, dividends, interest, discounts and premiums, annuities, rents, and royalties. Amounts and timing with respect to items of business income and deduction are generally determined by commercial accounting rules. There is no income tax on capital gains. However, it is proposed that profits from the sale by any person of shares, subject to certain exemptions, will be taxed at 15 percent, effective April 1, 2004. Sri Lanka offers several incentives by law or under special agreements with the Sri Lanka Board of Investment.

Individuals

Individuals resident in Sri Lanka are subject to tax on their worldwide income. For most types of income, rate brackets are generally progressive from zero to 30 percent. Certain social security and retirement benefits are subject to a 15 percent maximum rate. Dividends and interest are generally taxed on a final withholding basis at a rate of 10 percent.

Companies

Companies resident in Sri Lanka are subject to income tax on their worldwide income. The general rate applicable for quoted companies is 30 percent and for nonquoted companies is 32.5 percent (inclusive of 2.5 percent for the Human Resources Endowment Fund). However, when the taxable income is less than five million Sri Lanka rupees (approximately $51,000), the applicable rate is 20 percent. Dividends distributed by resident companies and interest are generally taxed at 10 percent.

[3] The information in this section relates to foreign law and is based on the Joint Committee staff's review of publicly available secondary sources and comments from the government of Sri Lanka. The description is intended to serve as a general overview; it may not be fully accurate in all respects, as many details have been omitted and simplifying generalizations made for ease of exposition. Major law changes under the 2004 proposed Budget, expected to apply from April 1, 2004, are noted.

B. International Aspects of Domestic Sri Lankan Law

Residency

Generally, resident individuals and companies are subject to income tax on their worldwide income, while nonresident individuals and companies are subject to tax only on income from sources in Sri Lanka. Individuals are generally resident for tax purposes if they are present in Sri Lanka for more than 183 days in a tax year. However, noncitizens employed in Sri Lanka are deemed to be nonresidents for the first three years of employment. After the expiration of this three-year period, they are considered to be residents and are taxed on worldwide income. A noncitizen of Sri Lanka is subject to income tax on his income derived from employment in Sri Lanka at a reduced rate of 15 percent for the first five years of employment. A company is resident in Sri Lanka if its registered or principal office is in Sri Lanka, or if the control and management of its business are exercised in Sri Lanka.

Source of income

Income from sources in Sri Lanka includes income derived from services rendered in Sri Lanka, from property in Sri Lanka, and from business transacted in Sri Lanka directly or though an agent. The concept of "permanent establishment" is not used in Sri Lankan internal tax law.

Nonresident withholding

Sri Lanka imposes on resident companies a withholding tax of 10 percent on dividends distributed out of profits on which their taxable income is computed. Sri Lanka also imposes a tax of 10 percent on remittances paid out of the taxable income of a nonresident company.

Sri Lanka-source interest payments to nonresident individuals and foreign corporations are generally subject to withholding tax on the gross interest payments at a rate of 20 percent.

Sri Lanka-source royalties paid to nonresident individuals and foreign corporations are generally subject to a 20-percent withholding tax on the gross payments.

In the absence of a treaty, Sri Lanka generally provides double tax relief by way of a deduction from foreign income.

C. Other Taxes

Economic service charge ("ESC"), a minimum tax, will be imposed at the rate of one percent of turnover or total assets, generally effective April 1, 2004 (effective for certain taxpayers April 1, 2005). ESC will apply to any person or partnership carrying on any trade, business, profession or vocation, which has operated commercially for more than two years and with a turnover exceeding 30 million rupees or total assets of more than 10 million. The minimum charge will be 100,000 and the maximum 20 million. ESC will be set off against income tax payable for the same year only and will not be allowed to be carried forward.

In addition to the taxes described above, other taxes are levied at the national or local levels. Additional national taxes include a VAT at a standard 15 percent rate, excise taxes on tobacco, liquor, tea and certain other items, and stamp tax. A debit tax of 0.1 percent is imposed on debits to current or savings accounts, and on the cashing of certificates of deposit and traveler's checks. Sri Lanka also has a Social Security system funded by employer and employee contributions. Property taxes are imposed at the local level.

IV. EXPLANATION OF PROPOSED TREATY

Article 1. Personal Scope

Overview

The personal scope article describes the persons who may claim the benefits of the proposed treaty. The proposed treaty generally applies to residents of the United States and to residents of Sri Lanka, with specific modifications to such scope provided in other articles (e.g., Article 20 (Government Service), Article 25 (Non-Discrimination) and Article 27 (Exchange of Information)). The determination of whether a person is a resident of the United States or Sri Lanka is made under the provisions of Article 4 (Resident).

The proposed treaty provides that it does not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance accorded by internal law or by any other agreement between the United States and Sri Lanka. Thus, the proposed treaty will not apply to increase the tax burden of a resident of either the United States or Sri Lanka. According to the Treasury Department's Technical Explanation (hereinafter referred to as the "Technical Explanation"), the fact that the proposed treaty only applies to a taxpayer's benefit does not mean that a taxpayer may select inconsistently among treaty and internal law provisions in order to minimize its overall tax burden. In this regard, the Technical Explanation sets forth the following example. Assume a resident of Sri Lanka has three separate businesses in the United States. One business is profitable and constitutes a U.S. permanent establishment. The other two businesses generate effectively connected income as determined under the Internal Revenue Code (the "Code"), but do not constitute permanent establishments as determined under the proposed treaty; one business is profitable and the other business generates a net loss. Under the Code, all three businesses would be subject to U.S. income tax, in which case the losses from the unprofitable business could offset the taxable income from the other businesses. On the other hand, only the income of the business which gives rise to a permanent establishment is taxable by the United States under the proposed treaty. The Technical Explanation makes clear that the taxpayer may not invoke the proposed treaty to exclude the profits of the profitable business that does not constitute a permanent establishment and invoke U.S. internal law to claim the loss of the unprofitable business that does not constitute a permanent establishment to offset the taxable income of the permanent establishment.[4]

The proposed treaty provides that the dispute resolution procedures under its mutual agreement procedure article (Article 26) (and not the corresponding provisions of any other agreement to

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

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

Saving clause

Like all U.S. income tax treaties and the U.S. model, the proposed treaty includes a "saving clause." Under this clause, with specific exceptions described below, the proposed treaty does not 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 Sri Lanka as if the treaty were not in force. "Residents" for purposes of the proposed treaty (and, thus, for purposes of the saving clause) includes persons defined as such in Article 4 (Resident), including corporations and other entities as well as individuals.

The proposed treaty contains a provision under which the saving clause (and therefore the U.S. jurisdiction to tax) applies to a former U.S. citizen or long-term resident (whether or not treated as such under Article 4 (Resident)), whose loss of citizenship or resident status, respectively, had as one of its principal purposes the avoidance of tax; such application is limited to the ten-year period following the loss of citizenship or resident status. Section 877 of the Code provides special rules for the imposition of U.S. income tax on former U.S. citizens and long-term residents for a period of ten years following the loss of citizenship or resident status; these special tax rules apply to a former citizen or long-term resident only if his or her loss of U.S. citizenship or resident status had as one of its principal purposes the avoidance of U.S. income, estate or gift taxes. For purposes of applying the special tax rules to former citizens and long-term residents, individuals who meet a specified income tax liability threshold or a specified net worth threshold generally are considered to have lost citizenship or resident status for a principal purpose of U.S. tax avoidance.

Under U.S. domestic law, an individual is considered a "long-term resident" of the United States only if the individual (other than a citizen of the United States) was a lawful permanent resident of the United States in at least eight of the 15 taxable years ending with the taxable year in which the individual ceased to be a long-term resident. However, an individual is not treated as a lawful permanent resident for any taxable year if such individual is treated as a resident of a foreign country for such year under the provisions of a tax treaty between the United States and the for-

eign country and the individual does not waive the benefits of such treaty applicable to residents of the foreign country.

Exceptions to the saving clause are provided for the following benefits conferred by a treaty country: the allowance of correlative adjustments when the profits of an associated enterprise are adjusted by the other country (Article 9, paragraph 2); grants provided by Sri Lanka in respect of an enterprise in Sri Lanka owned by a resident of the United States (Article 14); the exemption from source- and residence-country tax for certain pension, social security, alimony, and child support payments (Article 19, paragraphs 2 and 3); relief from double taxation through the provision of a foreign tax credit (Article 24); protection from discriminatory tax treatment with respect to transactions with residents of the other country (Article 25); and benefits under the mutual agreement procedures (Article 26). These exceptions to the saving clause permit residents or citizens of the United States or Sri Lanka to obtain such benefits of the proposed treaty with respect to their country of residence or citizenship.

In addition, the saving clause does not apply to certain benefits conferred by one of the countries upon individuals who neither are citizens of that country nor have been admitted for permanent residence in that country. Under this set of exceptions to the saving clause, the specified treaty benefits are available to, for example, a citizen of Sri Lanka who spends enough time in the United States to be taxed as a U.S. resident but who has not acquired U.S. permanent residence status (i.e., does not hold a "green card"). The benefits that are covered under this set of exceptions are the exemptions from host country tax for certain compensation from government service (Article 20), certain income received by visiting students and trainees (Article 21), and the income of diplomatic agents and consular officers (Article 28).

Article 2. Taxes Covered

The proposed treaty generally applies to the income and capital gains taxes of the United States and Sri Lanka. However, Article 25 (Non-Discrimination) of the proposed treaty is applicable to all taxes imposed at all levels of government, including state and local taxes.

In the case of the United States, the proposed treaty applies to the Federal income taxes imposed by the Code, but excludes social security taxes. Unlike the U.S. model, the proposed treaty excludes from coverage the accumulated earnings tax and the personal holding company tax. However, such taxes will not apply to most foreign corporations because of a statutory exclusion or the corporation's failure to meet a statutory requirement under the Code. In the cases where these taxes do apply, the amount of tax liability is likely to be insignificant.

Article 2 of the 1985 treaty provides that the U.S. insurance excise tax with respect to U.S. risks is included among covered taxes, and provides a waiver of this U.S. excise tax, subject to an "anti-conduit" rule. The protocol modifies Article 2 to provide that the U.S. insurance excise tax is not a covered tax. As a result, the proposed treaty, as modified by the protocol, would not eliminate this tax, so Sri Lankan insurers would be required to pay the excise tax

on premiums received for the insurance or reinsurance of U.S. risks.

In the case of Sri Lanka, the proposed treaty applies to the income tax, including the income tax based on the turnover of enterprises licensed by the Greater Colombo Economic Commission (hereafter referred to as "Sri Lankan tax").

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

Article 3. General Definitions

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

The term "Sri Lanka" means the Democratic Socialist Republic of Sri Lanka.

The term "United States" means the United States of America (including the States thereof and the District of Columbia), but does not include Puerto Rico, the Virgin Islands, Guam, or any other U.S. possession or territory. Unlike the U.S. model, the proposed treaty does not explicitly include certain areas under the sea within the definition of the United States. The Technical Explanation states that the territorial sea of the United States is included in the term "United States of America" because such term is interpreted by reference to the U.S. internal law definition and section 638 of the Code treats the continental shelf as part of the United States.

The term "Contracting State" means the United States or Sri Lanka, as the context requires.

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

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

The terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean, respectively, an enterprise carried on by a resident of a treaty country and an enterprise carried on by a resident of the other treaty country. The term "enterprise" is not defined in the proposed treaty, but the Technical Explanation states that it is understood such term refers to any activity or set of activities that constitute a trade or business. Like the U.S. model, these terms also include an enterprise conducted through an entity (such as a partnership) that is treated as fiscally transparent in the country where the entity's owner is resident.

The proposed treaty defines "international traffic" as any transport by a ship or aircraft, except when the transport is solely be-

tween places in the other treaty country. Accordingly, with respect to a Sri Lankan enterprise, purely domestic transport within the United States does not constitute "international traffic."

The term "national" means, in relation to the United States, all individuals who are United States citizens, and in the case of Sri Lanka, all individuals possessing the nationality of Sri Lanka. In the case of both the United States and Sri Lanka, a national is any legal person, partnership, or association deriving its status as such under the laws of the country where it is established.

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 Director, International (LMSB). On interpretative issues, the latter acts with the concurrence of the Associate Chief Counsel (International) of the IRS. The Sri Lankan "competent authority" is the Commissioner-General of Inland Revenue.

The term "qualified governmental entity" means a governing body of a treaty country or a political subdivision or local authority of a treaty country. Also defined as a qualified governmental entity is a person that is wholly owned (directly or indirectly) by a treaty country or a political subdivision or local authority thereof, provided it is organized under the laws of a treaty country, its earnings are credited to its own account with no portion of its income inuring to the benefit of any private person, and its assets vest in the treaty country, political subdivision or local authority upon dissolution. The proposed treaty also includes in the definition of the term "qualified governmental entity" government pension funds. The definitions described in the previous two sentences only apply if the entity does not carry on commercial activities. These definitions are the same as those in the U.S. model.

The proposed treaty also contains the standard provision that, unless the context otherwise requires or the competent authorities agree upon a common meaning pursuant to Article 26 (Mutual Agreement Procedure), all terms not defined in the proposed treaty have the meaning pursuant to the respective tax laws of the country that is applying the treaty.

Article 4. Resident

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

Internal taxation rules

United States

Under U.S. law, the residence of an individual is important because a resident alien, like a U.S. citizen, is taxed on his or her worldwide income, while a nonresident alien is taxed only on cer-

tain U.S.-source income and on income that is effectively connected with a U.S. trade or business. An individual who spends sufficient time in the United States in any year or over a three-year period generally is treated as a U.S. resident. A permanent resident for immigration purposes (i.e., a "green card" holder) also is treated as a U.S. resident.

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

Sri Lanka

Under Sri Lankan law, resident individuals and companies are generally subject to income tax on their worldwide income, while nonresident individuals and companies are subject to tax only on income from sources in Sri Lanka. Individuals are generally resident for tax purposes if they are present in Sri Lanka for more than 183-days in a tax year. However, noncitizens employed in Sri Lanka are deemed to be nonresidents for the first three years of employment.

After the expiration of this three-year period, noncitizens are considered to be residents and they are taxed on their worldwide income. A noncitizen of Sri Lanka is subject to income tax on income derived from employment in Sri Lanka at a reduced rate for the first five years of employment. A company is resident in Sri Lanka if its registered or principal office is in Sri Lanka, or if the control and management of its business are exercised in Sri Lanka.

Proposed treaty rules

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

The proposed treaty generally defines "resident of a Contracting State" to mean any person who, under the laws of that country, is liable to tax in that country by reason of the person's domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature. The term "resident of a Contracting State" does not include any person that is liable to tax in that country only on income from sources in that country or on profits attributable to a permanent establishment in that country.

The proposed treaty provides special rules to treat as residents of the United States certain organizations that generally are exempt from tax. Under these rules, a resident includes a legal person that is organized under the laws of the United States and is generally exempt from tax because it is established and maintained: (1) to provide pensions or other similar benefits to employees pursuant to a tax-exempt scheme or plan; or (2) exclusively for a religious, charitable, scientific, artistic, cultural, or educational purposes. A resident also includes a qualified governmental entity that is established in one of the treaty countries.

The proposed treaty provides a set of "tie-breaker" rules to determine residence in the case of an individual who, under the basic residence definition, would be considered to be a resident of both

countries. Under these rules, an individual is deemed to be a resident of the country in which he or she has a permanent home available. If the individual has a permanent home in both countries, the individual's residence is deemed to be the country with which his or her personal and economic relations are closer (i.e., his or her "center of vital interests"). If the country in which the individual has his or her center of vital interests cannot be determined, or if he or she does not have a permanent home available in either country, he or she is deemed to be a resident of the country in which he or she has an habitual abode. If the individual has an habitual abode in both countries or in neither country, he or she is deemed to be a resident of the country of which he or she is a national. If the individual is a national of both countries or neither country, the competent authorities of the countries will settle the question of residence by mutual agreement.

The proposed treaty also provides a set of "tie-breaker" rules with respect to dual resident companies. If such a person is, under the rules of paragraph 1 of this article, resident in both the United States and Sri Lanka, the residence of such company would be in the country under the laws of which it is organized or created. For example, a company is treated as resident in the United States if it is created or organized under the laws of the United States or a political subdivision. Under Sri Lankan law, a company is treated as a resident of Sri Lanka if it is either registered there, its principal office is there, or it is managed and controlled there. Dual residence, therefore, can arise in the case of a U.S. company is managed and controlled in Sri Lanka. The tie-breaker rules provide that the residence of such a company would be in the country under the laws of which it is created or organized (i.e., the United States, in the example).

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

The proposed treaty also provides that an individual who is a national of the United States or Sri Lanka will be considered to be a resident of such country if certain requirements are met. First, the individual must be an employee of such country or an instrumentality thereof in the other treaty country or a third country. Second, the individual must perform governmental functions for such country. Finally, the individual must be subject, in such country, to the same income tax obligations as are residents of that country. The spouse and minor children of an individual who meets the above requirements also will be considered to be residents of such country as long as they are, in their own right, subject to the same income tax obligations as are residents of such country.

Fiscally transparent entities

The proposed treaty contains special rules for fiscally transparent entities. Under these rules, income derived through an entity that is fiscally transparent under the laws of either treaty country is considered to be the income of a resident of one of the treaty countries only to the extent that the income is subject to tax in

that country as the income of a resident. For example, if a Sri Lankan company pays interest to an entity that is treated as fiscally transparent for U.S. tax purposes, the interest will be considered to be derived by a resident of the United States only to the extent that U.S. tax laws treat one or more U.S. residents (whose status as U.S. residents is determined under U.S. tax laws) as deriving the interest income for U.S. tax purposes.

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

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. However, the proposed treaty also includes several important deviations from the U.S. and OECD models in this regard. These deviations are described below and are discussed separately in Part V.C of this pamphlet, dealing with developing-country concessions.

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

In general, under the proposed treaty, a permanent establishment is a fixed place of business through which the business of an enterprise is wholly or partly carried on. A permanent establishment includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or other place of extraction of natural resources. It also includes a building site, a construction or assembly project, or an installation or drilling rig or ship used for the exploration of natural resources, if such project, or activity relating to such installation, rig, or ship, as the case may be, continues for more than 183 days. The Technical Explanation states that the 183-day test applies separately to each individual site or project, with a series of contracts or projects that are interdependent both commercially and geographically treated

as a single project. The Technical Explanation further states that if the 183-day threshold is exceeded, the site or project constitutes a permanent establishment as of the first day that work in the country began. These rules are similar to the rules in the U.S. model, but the U.S. model uses a threshold of 12 months, instead of 183 days. The 183-day threshold is consistent with the U.N. model and with other treaties that the United States has concluded with developing countries.

The proposed treaty also provides that the furnishing of services (e.g., consulting services) by an enterprise through employees or other personnel engaged for such purpose constitutes a permanent establishment for the enterprise if the activity continues within the country for an aggregate of more than 183 days in any 12–month period. This provision is a departure from the U.S. model but is consistent with the U.N. model.

Under the proposed treaty, the following activities are deemed not to constitute a permanent establishment: (1) the use of facilities solely for storing, displaying, or delivering goods or merchandise belonging to the enterprise; (2) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for storage, display, or delivery or solely for processing by another enterprise; and (3) the maintenance of a fixed place of business solely for the purchase of goods or merchandise or for the collection of information for the enterprise. The proposed treaty also provides that the maintenance of a fixed place of business solely for the purpose of carrying on any other activity of a preparatory or auxiliary character does not constitute a permanent establishment. The proposed treaty further provides that no combination of these excepted activities will give rise to a permanent establishment. This is consistent with the U.S. model, which provides that any combination of otherwise excepted activities is deemed not to give rise to a permanent establishment, without the additional requirement (found in the OECD model) that the combination, as distinct from each individual activity, be preparatory or auxiliary.

Under the proposed treaty, if a person, other than an independent agent, is acting in a treaty country on behalf of an enterprise of the other country and has, and habitually exercises in such first country, the authority to conclude contracts in the name of such enterprise, the enterprise is deemed to have a permanent establishment in the first country in respect of any activities undertaken for that enterprise. This rule does not apply where the activities are limited to the preparatory and auxiliary activities described in the preceding paragraph. In addition, if a dependent agent maintains in one treaty country a stock of goods or merchandise from which the agent regularly fills orders or makes deliveries on behalf of an enterprise of the other treaty country, and additional activities conducted in the source country on behalf of the enterprise have contributed to the conclusion of the sale of such goods or merchandise, then the enterprise is deemed to have a permanent establishment in the source country. This provision is a departure from the U.S. model but is similar to a provision in the U.N. model.

The proposed treaty provides that an insurance enterprise of one treaty country will be deemed to have a permanent establishment

in the other treaty country if it collects premiums or insures risks situated in the other treaty country through a person other than an independent agent. This rule does not apply with respect to reinsurance. This provision is a departure from the U.S. model but is similar to a provision in the U.N. model.

Under the proposed treaty, no permanent establishment is deemed to arise if the agent is a broker, general commission agent, or any other agent of independent status, provided that the agent is acting in the ordinary course of its business. The Technical Explanation states that whether an enterprise and an agent are independent is a factual determination, and that the relevant factors in making this determination include: (1) the extent to which the agent operates on the basis of instructions from the principal; (2) the extent to which the agent bears business risk; and (3) whether the agent has an exclusive or nearly exclusive relationship with the principal. Notwithstanding the preceding, the proposed treaty provides that if the activities of the agent are devoted wholly or almost wholly on behalf of the enterprise, and the transactions between the enterprise and the agent do not conform to arm's-length conditions, then the agent is not considered independent. This provision is a departure from the U.S. model but is similar to a provision in the U.N. model.

The proposed treaty provides that the fact that a company that is a resident of one country controls or is controlled by a company that is a resident of the other country or that carries on business in the other country does not in and of itself cause either company to be a permanent establishment of the other.

Article 6. Income From Immovable Property

This article covers income from immovable property. The rules covering gains from the sale of immovable property are included in Article 13 (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 property is situated. This rule is consistent with the rules in the U.S. and OECD models.

The Technical Explanation states that the term "immovable property" is synonymous with the term "real property," as indicated by the parenthetical use of the term "real property" in the title of Article 6 of the proposed treaty. The term "immovable property" is the term used in the OECD model.

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.[5] The proposed treaty provides that income from real property includes income from property accessory to real property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting real 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 and other natural resources. Ships, boats, aircraft, and containers are not regarded as real property.

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

The proposed treaty specifies that the country in which the property is situated also may tax income derived from the direct use, letting, or use in any other form of real property. The rules of this article, permitting source-country taxation, also apply to the income from real property of an enterprise.

The proposed treaty does not grant an exclusive taxing right to the country where the property is situated; such country is merely given the primary right to tax. The proposed treaty does not include paragraph 5 of Article 6 of the U.S. model, regarding the allowance of an election to be taxed on a net basis on income from real property. However, both the United States and Sri Lanka allow non-residents to be taxed on income from real property on a net basis in the same manner as residents.

Article 7. Business Profits

Internal taxation rules

United States

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

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

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

Foreign-source income generally is effectively connected income only if the foreign person has an office or other fixed place of busi-

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

Any income or gain of a foreign person for any taxable year that is attributable to a transaction in another year is treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in that other year (Code sec. 864(c)(6)). In addition, if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, the determination of whether any income or gain attributable to a sale or exchange of that property occurring within 10 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)).

An excise tax is imposed on insurance premiums paid to a foreign insurer or reinsurer with respect to U.S. risks. The rate of tax is either four percent or one percent. The rate of the excise tax is four percent of the premium on a policy of casualty insurance or indemnity bond that is (1) paid by a U.S. person on risks wholly or partly within the United States, or (2) paid by a foreign person on risks wholly within the United States. The rate of the excise tax is one percent of the premium paid on a policy of life, sickness or accident insurance, or an annuity contract. The rate of the excise tax is also one percent of any premium for reinsurance of any of the foregoing types of contracts.

Two exceptions to the application of the insurance excise tax are provided. One exception is for amounts that are effectively connected with the conduct of a U.S. trade or business (provided no treaty provision exempts the amounts from U.S. taxation). Thus, under this exception, the insurance excise tax does not apply to amounts that are subject to U.S. income tax in the hands of a foreign insurer or reinsurer pursuant to its election to be taxed as a domestic corporation under Code section 953(d), or pursuant to its election under Code section 953(c) to treat related person insurance income as effectively connected to the conduct of a U.S. trade or business. The other exception applies to premiums on an indemnity bond to secure certain pension and other payments by the United States government.

Sri Lanka

Foreign corporations and nonresident individuals generally are subject to tax in Sri Lanka only on income arising in Sri Lanka. Business income derived in Sri Lanka by a foreign corporation or

nonresident individual generally is taxed in the same manner as the income of a resident corporation or individual.

Proposed treaty limitations on internal law

Under the proposed treaty, business profits of an enterprise of one of the countries are taxable in the other country only to the extent that they are attributable to a permanent establishment in the other country through which the enterprise carries on business. This is one of the basic limitations on a country's right to tax income of a resident of the other country. The rule is similar to those contained in the U.S. and OECD models. In addition, the proposed treaty provides that business profits of an enterprise of one of the countries also are taxable in the other country to the extent that they are attributable to (1) sales in the other country of goods or merchandise of the same or similar kinds as those sold through a permanent establishment in the other country, or (2) other business activities carried on in the other country of the same or similar kind as those effected through a permanent establishment in the other country. This limited "force of attraction" rule does not exist in the U.S. model but is similar to the U.N. model.

Although the proposed treaty does not provide a definition of the term "business profits," the Technical Explanation states that the term generally means income derived from any trade or business. The Technical Explanation also states that the term includes income attributable to notional principal contracts and other financial instruments to the extent that the income is attributable to a trade or business of dealing in such instruments or is otherwise related to a trade or business (e.g., notional principal contracts entered into for the purpose of hedging currency risk arising from an active trade or business). Any other income derived from financial instruments is addressed in Article 22 (Other Income), unless specifically governed by another article.

The proposed treaty provides that there will be attributed to a permanent establishment the business profits which it might be expected to make if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions. The Technical Explanation states that this rule incorporates the arm's-length standard for purposes of determining the profits attributable to a permanent establishment.

In computing taxable business profits of a permanent establishment, the proposed treaty provides that deductions are allowed for expenses, wherever incurred, which are attributable to the activities 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, regardless of which accounting unit of the enterprise books the expenses, provided they are incurred for the purposes of the permanent establishment. The Technical Explanation states that this rule permits, but does not require, each treaty country to apply the type of expense allocation rules provided by U.S. internal law.[6]

[6] *See, e.g.,* Treas. reg. secs. 1.861–8 and 1.882–5.

The proposed treaty does not permit a permanent establishment to deduct payments that it makes to the head office, or any other office, of the enterprise that includes the permanent establishment if such payments constitute (1) royalties, fees or other similar payments in return for the use of patents, know-how or other rights, (2) commissions or other charges for specific services performed or for management, or (3) interest on loans to the permanent establishment. Similarly, such payments made to the permanent establishment by the head office or other office of the enterprise that includes the permanent establishment are not taken into account in determining the taxable business profits of the permanent establishment. This rule does not exist in the U.S. model but is similar to the U.N. model.

The proposed treaty permits a treaty country to determine the taxable business profits of a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various units, provided such determination is in accordance with the arm's-length standard and it has been customary for the treaty country to attribute profits to a permanent establishment using apportionment of total enterprise profits. This rule is similar to the OECD model but is not included in the U.S. model. The technical explanation of the U.S. model states that the rule is unnecessary because other provisions in this article already authorize the determination of permanent establishment profits using total profits apportionment. Although the proposed treaty includes this rule, the Technical Explanation reiterates the view of the Treasury Department that total profits apportionment is an acceptable method of determining the arm's-length profits of a permanent establishment under other provisions of this article.[7]

Like the U.S. model and the OECD model, the proposed treaty provides that business profits are not attributed to a permanent establishment merely by reason of the purchase of goods or merchandise by the permanent establishment for the enterprise. This rule is only relevant to an office that performs functions in addition to purchasing because such activity does not, by itself, give rise to a permanent establishment under Article 5 (Permanent Establishment) to which income can be attributed. When it applies, the rule provides that business profits may be attributable to a permanent establishment with respect to its non-purchasing activities (e.g., sales activities), but not with respect to its purchasing activities.[8]

The proposed treaty requires the determination of business profits of a permanent establishment to be made in accordance with the same method year by year unless a good and sufficient reason to the contrary exists.

Where business profits include items of income that are dealt with separately in other articles of the proposed treaty, those other articles, and not the business profits article, govern the treatment

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[7] *But see National Westminster Bank, PLC* v. *United States,* 44 Fed. Cl. 120 (1999); *North West Life Assurance Co. of Canada* v. *Commissioner,* 107 T.C. 363 (1996).

[8] The recently ratified income tax treaty between the United States and the United Kingdom does not include this rule on the grounds that it is inconsistent with the arm's-length principle, which would view a separate and distinct enterprise as receiving some compensation to perform purchasing services. *See, e.g.,* Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, Treaty Doc. 107–19.

of those items of income. Thus, for example, dividends are taxed under the provisions of Article 10 (Dividends), and not as business profits, except as specifically provided in Article 10.

The proposed treaty provides that, for purposes of the taxation of business profits, income may be attributable to a permanent establishment (and therefore may be taxable in the source country) even if the payment of such income is deferred until after the permanent establishment or fixed base has ceased to exist. This rule incorporates into the proposed treaty the rule of Code section 864(c)(6) described above. This rule applies with respect to business profits (Article 7, paragraphs 1 and 2), dividends (Article 10, paragraph 4), interest (Article 11, paragraph 5), royalties (Article 12, paragraph 5), capital gains (Article 13, paragraph 3), and independent personal services (Article 15).

The Technical Explanation notes that this article is subject to the savings clause of paragraph 3 of Article 1 (Personal Scope), as well as Article 23 (Limitation on Benefits). Thus, in the case of the savings clause, if a U.S. citizen who is a resident of Sri Lanka derives business profits from the United States that are not attributable to a permanent establishment in the United States, the United States may tax those profits, notwithstanding that paragraph 1 of this article would exempt the income from U.S. tax.

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 disposition of ships, aircraft, and containers are in Article 13 (Capital Gains).

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

The proposed treaty provides that income or profits derived by a U.S. resident from the operation of aircraft in international traffic is taxable only in the United States. Similarly, the proposed treaty provides that income or profits derived by a Sri Lankan resident from the operation of aircraft in international traffic is taxable only in Sri Lanka. The Technical Explanation states that such income derived by a resident of one of the countries may not be taxed in the other country even if the resident has a permanent establishment in that other country.

For purposes of the proposed treaty, income or profits derived from the operation of aircraft in international traffic include income or profits derived from the rental of aircraft if such aircraft are operated in international traffic by the lessee or if such rental income or profits are incidental to other income of the lessor from the operation of aircraft in international traffic. This provision is more generous than the provision found in many developing country treaties, which provides an exemption from source country taxation only if such rental income or profits were incidental to the

lessor and the aircraft was operated in international traffic by the lessee. Thus, the provision included in the proposed treaty is more consistent with the U.S. model, but still is not as generous as the U.S. model position. The U.S. model provides an exemption from source country tax for all incidental and nonincidental rental income and profits from ships and aircraft. The provision in the proposed treaty also deviates from the provision found in many recent U.S. income tax treaties with respect to rental income and profits from aircraft or ships. The provision found in many recent U.S. income tax treaties differentiates between full (i.e., with crew) and bareboat (i.e., without crew) leasing of aircraft and ships by providing an exemption from source country tax for full basis nonincidental rental income or profits but allowing for source country taxation of bareboat nonincidental rental income or profits. Under the proposed treaty, nonincidental rental income from both full and bareboat leasing of aircraft would be subject to source country tax if the aircraft is not used in international traffic by the lessee. The Technical Explanation states that the rental of aircraft is incidental to income from the operation of aircraft in international traffic if the lessor is a company, and the aircraft is part of the body of equipment used by the lessor in its business as an international carrier.

Unlike the U.S. model and most U.S. tax treaties, the rule granting the country of residence the exclusive right to tax income applies only with respect to income from the operation of aircraft in international traffic, and not to income from the operation of ships. Rather, the proposed treaty provides limited source country taxation of income from the operation of ships in international traffic. In this regard, the proposed treaty provides that the amount of Sri Lankan tax that may be imposed on income or profits derived by a resident of the United States from the operation of ships in international traffic shall not exceed 50 percent of the amount which would have been imposed in the absence of the proposed treaty. The proposed treaty limits the amount of shipping profits subject to tax in Sri Lanka to the lesser of 50 percent of the amount otherwise due or six percent of the gross receipts from passengers or freight embarked in Sri Lanka. Similarly, the proposed treaty provides that the amount of U.S. tax that may be imposed on income or profits derived by a resident of Sri Lanka from the operation of ships in international traffic shall not exceed 50 percent of the amount which would have been imposed in the absence of the proposed treaty. As an example, the Technical Explanation states that the income of a Sri Lankan shipping company from the operation of ships in international traffic would be limited to two percent of the company's U.S.-source gross transportation income from such operation (under section 887 of the Code, the U.S. tax rate on gross transportation income is four percent).

Under the proposed treaty, incidental income of a resident of the United States or Sri Lanka from the rental of ships operated by the lessee in international traffic on a full or bareboat basis is also subject to source country taxation. Such income is taxable in both the United States and Sri Lanka, but the rate of tax imposed by the source country may not exceed half the rate of tax applied to royalties under paragraph 3 of Article 12 (i.e., 2.5 percent). Noninci-

dental profits from *both* full and bareboat leasing of ships would be subject to full source country taxation.

However, the provisions allowing for source country taxation of shipping income are subject to an additional provision that states Sri Lanka will provide to the United States most-favored-nation treatment with respect to such shipping income. More specifically, the proposed treaty provides that the tax imposed by either Sri Lanka or the United States may not exceed the lowest rate that Sri Lanka agrees to in a treaty or other agreement with any other country for profits derived by residents of the other country on the operation of ships. The notes to the proposed treaty identify agreements with both the United Kingdom and Poland in which Sri Lanka has exempted from source country taxation "profits from the operation of ships or aircraft in international traffic." With respect to the OECD model, OECD Commentary under paragraph 5 of Article 8 (Shipping, Inland Waterways Transport, and Air Transport) states, "profits obtained by leasing a ship or aircraft on charter fully equipped, manned and supplied must be treated like the profits from the carriage of passengers or cargo. Otherwise, a great deal of business of shipping or air transport would not come within the scope of the provision." Based on OECD Commentary, all income and profits from leases on a *full* basis would be exempt from tax in Sri Lanka. Thus, after applying the most-favored-nation provision, the proposed treaty would currently grant full exemption for income or profits from the operation of ships, incidental income from the full or bareboat rental of ships, and nonincidental income from the full basis rental of ships.

"International traffic" means any transport by a ship or aircraft, except where the transport is solely between places in the other country (Article 3(1)(g), General Definitions). Accordingly, with respect to a Sri Lankan enterprise, purely domestic transport within the United States does not constitute "international traffic."

The proposed treaty provides that profits of an enterprise of a country from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) used for the transport of goods or merchandise in international traffic is taxable only in that country. Unlike the OECD model, this rule applies without regard to whether the recipient of the income is engaged in the operation of ships or aircraft in international traffic or whether the enterprise has a permanent establishment in the other country.

Under the proposed treaty, as under the U.S. model, the shipping and air transport provisions apply to profits derived 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 notes that this article is subject to the savings clause of paragraph 4 of Article 1 (Personal Scope), as well as Article 23 (Limitation on Benefits).

Article 9. Associated Enterprises

The proposed treaty, like most other U.S. tax treaties, contains an arm's-length pricing provision. The proposed treaty recognizes the right of each country to make an allocation of profits to an en-

terprise of that country in the case of transactions between related enterprises, if conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises. In such a case, a country may allocate to such an enterprise the profits which it would have accrued but for the conditions so imposed. This treatment is consistent with the U.S. model.

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

Under the proposed treaty, when a redetermination of tax liability has been made by one country under the provisions of this article, the other country will make an appropriate adjustment to the amount of tax paid in that country on the redetermined income. In making such adjustment, due regard is to be given to other provisions of the proposed treaty. The proposed treaty's saving clause retaining full taxing jurisdiction in the country of residence or citizenship does not apply in the case of such adjustments. Accordingly, internal statute of limitations provisions do not prevent the allowance of appropriate correlative adjustments. However, the Technical Explanation states that statutory or procedural limitations cannot be overridden to impose additional tax because paragraph 4 of Article 1 (Personal Scope) provides that the proposed treaty cannot restrict any statutory benefit.

The proposed treaty does not limit any provisions of either country's internal law that permit the distribution, apportionment, or allocation of income, deductions, credits, or allowances between related parties. The Technical Explanation states that this extends to adjustments in cases involving the evasion of taxes or fraud. The Technical Explanation further states that any such adjustments are permitted even if they are different from, or go beyond, those specifically authorized by this article, as long as they are in accord with general arm's-length principles.

Article 10. Dividends

Internal taxation rules

United States

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

Under U.S. law, the term dividend generally means any distribution of property made by a corporation to its shareholders, either from accumulated earnings and profits or current earnings and profits. However, liquidating distributions generally are treated as payments in exchange for stock and, thus, are not subject to the

30-percent withholding tax described above (see discussion of capital gains in connection with Article 13 below).

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

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

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

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

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

Sri Lanka

Sri Lanka imposes a tax of 10 percent on gross dividend payments made by Sri Lankan companies.

Proposed treaty limitations on internal law

Under the proposed treaty, dividends paid by a company that is a resident of a treaty country to a resident of the other country may be taxed in such other country. Such dividends also may be taxed by the country in which the payor company is resident (the "source country"), but the rate of such tax is limited. Under the proposed treaty, source-country taxation of dividends is limited to 15 percent of the gross amount of the dividends paid to residents of the other treaty country.

The proposed treaty defines the term "dividends" as income from shares (or other participation rights that are not treated as debt under the law of the source country), as well as other amounts that are subjected to the same tax treatment as income from shares by the source country (e.g., constructive dividends).

The term "beneficial owner" is not defined in the present treaty or the proposed treaty, and thus is defined under the internal law of the source country. The Technical Explanation states that the beneficial owner of a dividend for purposes of this article is the person to which the dividend income is attributable for tax purposes under the laws of the source country. Further, companies holding shares through fiscally transparent entities such as partnerships are considered to hold their proportionate interest in the shares, according to the Technical Explanation.

The 15-percent maximum rate of withholding tax is allowed for dividends paid by a REIT only if one of three conditions is met: (1) the person beneficially entitled to the dividend is an individual holding an interest of not more than 10 percent in the REIT; (2) the dividend is paid with respect to a class of stock that is publicly traded, and the person beneficially entitled to the dividend is a person holding an interest of not more than five percent of any class of the REIT's stock; or (3) the person beneficially entitled to the dividend holds an interest in the REIT of not more than 10 percent, and the REIT is "diversified" (i.e., the gross value of no single interest in real property held by the REIT exceeds 10 percent of the gross value of the REIT's total interest in real property).

The Technical Explanation indicates that the restrictions on availability of the lower rates are intended to prevent the use of REITs to gain unjustifiable source-country benefits for certain shareholders resident in Sri Lanka. For example, a resident of Sri Lanka directly holding real property would be required to pay U.S. tax either at a 30-percent rate on gross income or at graduated rates on the net income from the property. By placing the property in a REIT, the investor could transform real estate income into dividend income, taxable at the 15-percent rate provided in the proposed treaty. The limitations on REIT dividend benefits are intended to protect against this result.

The proposed treaty's reduced rates of tax on dividends do not apply if the dividend recipient carries on business through a permanent establishment or fixed base in the source country, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such cases, the dividends effectively connected to the permanent establishment may be taxed as business profits (Article 7) or independent personal services income (Article 15), as the case may be.

The Technical Explanation notes that the saving clause of paragraph 3 of Article 1 (Personal Scope) permits the United States to tax dividends received by its residents and citizens, subject to the foreign tax credit rules of paragraph 1 of Article 24 (Relief from Double Taxation), as if the proposed treaty had not come into effect.

The benefits of the dividends article are also subject to the provisions of Article 23 (Limitation on Benefits). Thus, if a resident of Sri Lanka is the beneficial owner of dividends paid by a U.S. company, the shareholder must qualify for treaty benefits under at least one of the tests of Article 23 in order to receive the benefits of the dividends article.

Article 11. Interest

Internal taxation rules

United States

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

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

If an investor holds an interest in a fixed pool of real estate mortgages that is a real estate mortgage interest conduit ("REMIC"), the REMIC generally is treated for U.S. tax purposes as a pass-through entity and the investor is subject to U.S. tax on a portion of the REMIC's income (generally, 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.

Sri Lanka

Interest paid to residents generally is subject to withholding tax at a rate of 10 percent. Interest paid to nonresidents generally is subject to withholding tax at a rate of 20 percent.

Proposed treaty limitations on internal law

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

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

The proposed treaty provides a complete exemption from source country tax in the case of interest arising in a treaty country if (1) the payer of the interest is the Government of such treaty country, or a political subdivision or local authority thereof, (2) the interest is derived and beneficially owned by the Government of the other treaty country (including, in the case of the United States, the Export-Import Bank and the Overseas Private Investment Corporation), or (3) the interest is paid to the Federal Reserve Banks of the United States or the Central Bank of Ceylon.

The proposed treaty, as amended by the proposed protocol, defines the term "interest" as interest from government securities, bonds, debentures, and any other form of indebtedness, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits. The term also includes all other income that is treated as interest under the internal law of the country in which the income arises. Interest does not include income covered in Article 10 (Dividends). Penalty charges for late payment also are not treated as interest.

The reductions in source country tax on interest under the proposed treaty do not apply if the beneficial owner of the interest carries on business through a permanent establishment in the source country and the interest paid is attributable to the permanent establishment. In such an event, the interest is taxed under Article 7 (Business Profits). The reduced rates of tax on interest under the proposed treaty also do not apply if the beneficial owner is a treaty country resident who performs independent personal services from a fixed base located in the other treaty country and such interest is attributable to the fixed base. In such a case, the interest attributable to the fixed base is taxed under Article 15 (Independent Personal Services).

As amended by the proposed protocol, the proposed treaty provides two anti-abuse exceptions to the general source-country reduction in tax discussed above. The first exception provides that

the reductions in and exemption from source-country tax do not apply to excess inclusions with respect to a residual interest in a REMIC. Such income may be taxed in accordance with each country's internal law. The second anti-abuse exception relates to "contingent interest" payments. Contingent interest paid by a source-country resident to a resident of the other country may be taxed in the source country in accordance with its internal laws if the interest is of a type that does not qualify as portfolio interest under U.S. law (or is of a similar type under the internal laws of Sri Lanka).[9] However, if the beneficial owner is a resident of the other country, such interest may not be taxed at a rate exceeding 15 percent (i.e., the rate prescribed in paragraph 2 of Article 10 (Dividends)).

As amended by the proposed protocol, the proposed treaty provides that interest is treated as arising in a treaty country if the payer is the Government of such treaty country, a political or administrative subdivision or local authority thereof, or a resident of that country.[10] However, if the interest expense is borne by a permanent establishment, fixed base or a trade or business subject to tax in the source country on a net basis under Article 6 (Income from Immovable Property (Real Property)) or paragraph 1 of Article 13 (Capital Gains), the interest will have as its source the country in which the permanent establishment, fixed base or trade or business is located, regardless of the residence of the payer. Thus, for example, if an Indian resident has a permanent establishment in Sri Lanka and that Indian resident incurs indebtedness to a U.S. person, the interest on which is borne by the Sri Lankan permanent establishment, the interest would be treated as having its source in Sri Lanka.

The proposed treaty addresses the issue of non-arm's-length interest charges between related parties (or parties having an otherwise special relationship) by stating that this article applies only to the amount of arm's-length interest. Any amount of interest paid in excess of the arm's-length interest is taxable according to the laws of each country, taking into account the other provisions of the proposed treaty and the proposed protocol. For example, excess interest paid to a parent corporation may be treated as a dividend under local law and, thus, entitled to the benefits of Article 10 (Dividends). The Technical Explanation provides that if the amount of interest paid is less than the amount that would have been paid in the absence of the special relationship, a treaty country may characterize a transaction to reflect its substance and impute interest under the authority of Article 9 (Associated Enterprises).

Article 12. Royalties

The proposed treaty retains source-country taxation of royalties, but limits the maximum level of withholding tax to 10 percent for

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[9] *See* Code secs. 871(h)(4) and 881(c)(4). The Technical Explanation describes such interest as interest that is determined by reference to the receipts, sales, income, profits or other cash flow of the debtor or a related person, to any change in the value of any property of the debtor or a related person or to any dividend, partnership distribution or similar payment made by the debtor or a related person.

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

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 interests in real property. The tax is imposed on the dividend-equivalent amount, as defined in the Code (generally, the dividend amount a U.S. branch office would have paid up to its parent for the year if it had been operated as a separate U.S. subsidiary). In cases in which a Sri Lanka 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 would otherwise impose on such corporation (unless the corporation earned income from real property as described above).

The United States is also allowed under the proposed treaty to impose the branch excess interest tax (at a rate of 10 percent). In this regard, the proposed treaty provides that the United States may impose this tax on the excess, if any, of the enterprise's interest expense allocable to the branch over the amount of interest paid by the branch.

Sri Lanka is allowed to impose branch taxes under these same conditions and subject to the same limitations.

Article 13. Capital Gains

Internal taxation rules

United States

Generally, gain realized by a nonresident alien or a foreign corporation from the sale of a capital asset is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S. trade or business or, in the case of a nonresident alien, he or she is physically present in the United States for at least 183 days in the taxable year. However, the Foreign Investment in Real Property Tax Act ("FIRPTA"), effective June 19, 1980, extended the reach of U.S. taxation to dispositions of U.S. real property by foreign corporations and nonresident aliens regardless of their physical presence in the United States.

Under FIRPTA, the nonresident alien or foreign corporation is subject to U.S. tax on the 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 ("U.S. real property holding corporation"). FIRPTA contained a provision expressly overriding any tax treaty but generally delaying such override until after December 31, 1984.[11]

Sri Lanka

Sri Lanka abolished the tax on capital gains, effective April 1, 2002.

Proposed treaty limitations on internal law

The proposed treaty specifies rules governing when a country may tax gains from the alienation of property by a resident of the other country. Generally, except as described below with respect to

[11] *See* Foreign Investment in Real Property Tax Act, Pub. L. No. 96–499, sec. 1125(c)(1) (1980).

real property and certain other property, gains from disposition of any property are taxable only by the treaty country in which the alienator is resident.

Under the proposed treaty, gains derived by a resident of one treaty country from the alienation of immovable property situated in the other country may be taxed in the country in which the property is situated. For the purposes of this article, immovable property includes "immovable property" situated in a treaty country, as defined in Article 6 (Income from Immovable Property) of the proposed treaty. That definition has the same meaning which it has under the laws of the treaty country in which the property in question is situated, and specifically includes real property, 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 immovable property, and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. In the case of the United States, immovable property also includes a United States real property interest. In the case of Sri Lanka, immovable property also includes an interest in a company the assets of which consist, directly or indirectly, principally of immovable property referred to in Article 6, and an interest in a partnership, trust or estate to the extent directly or indirectly attributable to immovable property.

Thus, the proposed treaty permits the United States to apply the FIRPTA rules of Code section 897 to tax a resident of Sri Lanka on the disposition of shares in a U.S. company that owns sufficient U.S. real property interests on certain testing dates to qualify as a U.S. real property holding corporation. The Technical Explanation states that in applying these rules, the United States will look through capital gain distributions made by a REIT. Consequently, distributions made by a REIT that are attributable to gains derived from the alienation of real property are taxable under paragraph 1 of Article 13, and not under Article 10 (Dividends).

The proposed treaty contains a provision that permits a treaty country to tax gains from the alienation of property (other than real property) that forms a part of the business property of a permanent establishment located in that country. The rule also applies to a fixed base located in a treaty country that is available to a resident of the other treaty country for the purpose of performing independent personal services. This rule also applies to gains from the alienation of such a permanent establishment (alone or with the enterprise as a whole), or such fixed base. The Technical Explanation states that a resident of Sri Lanka that is a partner in a partnership doing business in the United States generally will have a permanent establishment in the United States as a result of the activities of the partnership, assuming that the activities of the partnership rise to the level of a permanent establishment.[12] The Technical Explanation further states that under this provision, the United States generally may tax a partner's distributive share of income realized by a partnership on the disposition of

[12] *See* Rev. Rul. 91–32, 1991–1 C.B. 107.

personal (movable) property forming part of the business property of the partnership in the United States.

The proposed treaty provides that gains derived by an enterprise carried on by a resident of a treaty country from the alienation of ships, aircraft, or containers operated or used in international traffic by such enterprise, and any personal property pertaining to the operation or use of such ships, aircraft, or containers are taxable only in such country. Article 3 defines "international traffic" as any transport by ship or aircraft, except where such transport is solely between places in the other treaty country. The Technical Explanation states that this rule applies even if the income of the enterprise is attributable to a permanent establishment in the other treaty country. The result is consistent with the allocation of taxing rights under the U.S. model.

Under the proposed treaty, gains of a resident of a treaty country from the alienation of shares of a company which is a resident of the other treaty country, representing a participation of 50 percent or more, may be taxed in that other treaty country.

Gains from the alienation of any property other than that discussed above, is taxable under the proposed treaty only in the country where the person alienating the property is resident, to the extent that the gain is not otherwise characterized as income taxable under another article (e.g., Article 10 (Dividends) or Article 11 (Interest)). Gains derived from the alienation of any right or property that produce income taxable under Article 12, pertaining to royalties, are taxable in accordance with Article 12 only if such gains are contingent on the productivity, use or disposition of such property.

Notwithstanding the foregoing limitations of certain gains by the country of source, the saving clause of paragraph 3 of Article 1 (Personal Scope) permits the United States to tax its citizens and residents as if the treaty had not gone into effect. The benefits of this article are also subject to the provisions of Article 23 (Limitations on Benefits). Thus, only a resident that satisfies one of the conditions in Article 23 is entitled to the benefits of this article.

Article 14. Grants

The proposed treaty contains the rules found in the 1985 treaty relating to grants. The rules are not included in the U.S. model, nor are they generally included in U.S. treaties, but similar provisions relating to grants are included in the U.S.-Israel treaty.

The proposed treaty provides for the exclusion from income and from earnings and profits for U.S. tax purposes of a cash grant or payment by the government of Sri Lanka to a U.S. resident in respect of a wholly owned enterprise in Sri Lanka, or to a company resident in Sri Lanka that is wholly owned by a U.S. resident. The cash grant or payment is to be for the purposes of investment promotion and economic development in Sri Lanka.

If the cash grant or payment is made to a U.S. resident that is a company, it is treated as a contribution to capital of the U.S. resident that is then deemed to be contributed to the Sri Lanka company designated under the grant. The basis of the stock of the Sri Lanka company in the hands of the U.S. resident is not increased by the amount of the deemed contribution. Further, the basis of the

Sri Lanka company's property is reduced by the amount of the deemed contribution. This basis reduction rule is similar to the U.S. tax rule that would likely apply absent the application of this article in the case of a Sri Lanka company that is a corporation. That rule requires reduction of the basis of property acquired by a corporation within 12 months after a nonshareholder contribution to capital (Code section 362(c)). Consequently, for U.S. tax purposes, the Sri Lanka corporation's basis in its assets so acquired would be reduced for U.S. tax purposes. The proposed treaty does not provide for the situation in which a U.S. resident acquires assets directly from the proceeds of a grant. The result of applying the U.S. domestic tax rules in this situation would be similar, however; that is, if the U.S. resident in this situation is a corporation, the rules of Code section 362(c) require a reduction in the basis of the corporation's assets.

If the cash grant or payment is made to a company that is a resident of Sri Lanka, the amount of the grant or payment is treated as a contribution to capital, and the basis of the company's property is reduced by the amount of the contribution in accordance with rules prescribed by the U.S. Treasury Department.

Under the proposed treaty, the cash grant or similar payment may not include any amount that is in whole or in part, directly or indirectly, in consideration for services or for the sale or goods, is measured in any manner by the amount of profits or tax liability, or is taxed by Sri Lanka.

The proposed treaty provides that a U.S. resident who receives a cash grant or payment may elect to include it in gross income for U.S. tax purposes, and in the case of such an election, the grant provisions of the proposed treaty do not apply.

Article 15. Independent Personal Services

Internal taxation rules

United States

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

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

Sri Lanka

Fees paid to nonresidents for professional services and certain other services are subject to withholding tax at a rate of five percent levied on the gross amount.

Proposed treaty limitations on internal law

Under the proposed treaty, income derived by an individual who is a resident of one treaty country from the performance of personal services in an independent capacity is generally taxable only in such country (the "residence country"). However, if the services are performed in the other treaty country (the "source country"), then the income also may be taxed by the source country if either: (1) the individual is present in the source country for a total of more than 183 days during any 12-month period; or (2) the income is attributable to a "fixed base" regularly available to the individual in the source country for the purpose of performing the activities.

The proposed treaty does not define the term "personal services in an independent capacity," but the Technical Explanation states that the term clearly includes independent scientific, literary, artistic, educational or teaching activities, and the independent activities of physicians, lawyers, engineers, architects, dentists, and accountants, to the extent not dealt with in other articles of the proposed treaty (e.g., Article 18 (Artistes and Athletes)). In determining whether the activities are "independent," the focus is on whether the individual receives the income and bears the risk of loss arising from the activities, whether as a sole proprietor or as a partner.

The Technical Explanation states that the term "fixed base" is understood to be similar, but not identical, to the term "permanent establishment," as defined in Article 5 of the proposed treaty. The Technical Explanation explains that the determination of whether a fixed base is regularly available to an individual is made on the basis of all relevant facts and circumstances. The Technical explanation provides the example that a U.S. resident who is a partner in a U.S. law firm with offices in Sri Lanka would be considered to have a fixed base regularly available to him or her in Sri Lanka if the firm had an office there that was available to the partner whenever he wished to conduct business in Sri Lanka.

The provisions of this article represent a departure from the U.S. model, which provides for source-country taxation of independent personal services only to the extent of income that is attributable to a fixed base. The provisions of this article are, however, similar to the provisions of the U.N. model and to those found in other treaties that the United States has concluded with developing countries.

This article is subject to the saving clause of paragraph 3 of Article 1 (Personal Scope). Thus, if a U.S. citizen who is resident in Sri Lanka performs independent personal services in the United States, the United States may tax the income attributable to such services without regard to the restrictions of this article, subject to the foreign tax credit described in Article 24 (Relief from Double Taxation).

Article 16. Dependent Personal Services

Under the proposed treaty, as amended by the proposed protocol, salaries, wages, and other remuneration derived from services performed as an employee in one treaty country (the source country) by a resident of the other treaty country are taxable only by 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 12-month period commencing or ending in the taxable year or year of assessment concerned; (2) the individual is paid by, or on behalf of, an employer who is not a resident of the source country; and (3) the remuneration is not borne by a permanent establishment or fixed base of the employer in the source country. These limitations on source country taxation are similar to the rules of the U.S. model and OECD model.

The proposed treaty contains a special rule that permits remuneration derived by a resident of one treaty country with respect to employment as a regular member of the crew of a ship or aircraft operated in international traffic by an enterprise of the other treaty country to be taxed only in the treaty country of residence of the enterprise operating the ship or aircraft. This provision is contrary to the U.S. model, which provides that such remuneration may be taxed only in the treaty country of residence of the employee.

This article is subject to the provisions of the separate articles covering artistes and athletes (Article 18), pensions, social security, and child support payments (Article 19), and government service income (Article 20).

Article 17. Directors' Fees

Under the proposed treaty, director's fees and other similar payments derived by a resident of one country for services rendered in the other country in his or her capacity as a member of the board of directors of a company that is a resident of that other country is taxable in that other country. Under the proposed treaty, as under the U.S. model, the country of the company's residence may tax the remuneration of nonresident directors, but only with respect to remuneration for services performed in that country.

Article 18. Artistes and Athletes

Like the U.S. and OECD models, the proposed treaty contains a separate set of rules that apply to the taxation of income earned by entertainers (such as theater, motion picture, radio, or television artistes or musicians) and athletes. These rules may take precedence over the other provisions dealing with the taxation of income from independent and dependent personal services (Article s 15 and 16) 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. This article applies only with respect to the income of entertainers and athletes. Others involved in a performance or athletic event, such as producers, directors, technicians, managers, coaches, etc., remain subject to the provisions of Article s 15 and 16. In addition, except as provided in paragraph 2 of this article, income earned by legal persons is not covered by this article.

Under the proposed treaty, income derived by an entertainer or athlete who is a resident of one country from his or her personal activities as such in the other country may be taxed in the other country if the amount of the gross receipts derived by him or her from such activities exceeds $6,000 or its equivalent in Sri Lanka rupees. The $6,000 threshold includes expenses that are reimbursed to the entertainer or athlete or borne on his or her behalf. Under this rule, if a Sri Lanka entertainer maintains no fixed base in the United States and performs (as an independent contractor) in the United States for total compensation of $4,000 during a taxable year, the United States would not tax that income. If, however, that entertainer's total compensation were $7,000, the full amount would be subject to U.S. tax. If such entertainer earned $4,000 during a taxable year in the United States through a fixed base regularly available to him in the United States, the United States could tax him under the provisions of Article 15 (Independent Personal Services).

As described in the Technical Explanation, Article 18 of the proposed treaty applies to all income connected with a performance by the entertainer, such as appearance fees, award or prize money, and a share of the gate receipts. Income derived from a treaty country by a performer who is a resident of the other treaty country from other than actual performance, such as royalties from record sales and payments for product endorsements, is not covered by this article, but is covered by other articles, such as Article 12 (Royalties) or Article 15 (Independent Personal Services). For example, if an entertainer receives royalty income from the sale of live recordings, the royalty income would be subject to source country tax under Article 12 if the requirements of that article are met. In addition, the entertainer would be taxed under this article by the source country with respect to income from the performance itself if the dollar threshold is exceeded.

In determining whether income falls under Article 18 or another article, the controlling factor will be whether the income in question is predominantly attributable to the performance itself or other activities or property rights. For instance, a fee paid to a performer for endorsement of a performance in which the performer will participate would be considered to be so closely associated with the performance itself that it normally would fall within Article 18. Similarly, a sponsorship fee paid by a business in return for the right to attach its name to the performance would be so closely associated with the performance that it would fall under Article 18 as well. As indicated in the Technical Explanation, a cancellation fee would not be considered to fall within this article but would be dealt with under Article 7 (Business Profits), 15 (Independent Personal Services) or 16 (Dependent Personal Services).

The Technical Explanation states that if an individual fulfills a dual role as performer and non-performer (such as a player-coach or an actor-director), but his role in one of the two capacities is negligible, the predominant character of the individual's activities should control the characterization of those activities. In other cases there should be an apportionment between the performance-related compensation and other compensation.

Consistent with Article 16 (Dependent Personal Services), Article 18 also applies regardless of the timing of actual payment for services. Thus, a bonus paid to a resident of a Contracting State with respect to a performance in the other Contracting State with respect to a particular taxable year would be subject to Article 18 for that year even if it was paid after the close of the year.

The proposed treaty provides that the rules above do not apply to income derived from activities performed in a treaty country by entertainers or athletes if such activities are wholly or substantially supported by public funds of either treaty country, or of a political subdivision or a local authority thereof. In such a case the income is not taxable in the country in which the activities are performed.

The proposed treaty provides that where income in respect of activities performed by an entertainer or athlete in his or her capacity as such accrues not to the entertainer or athlete but to another person, that other person's income is taxable by the country in which the activities are performed unless it is established that neither the entertainer or athlete nor persons related to him or her participated directly or indirectly in the profits of that other person in any manner, including the receipt of deferred remuneration, bonuses, fees, dividends, partnership distributions, or other distributions. This provision prevents highly-paid entertainers and athletes from avoiding tax in the country in which they perform by, for example, routing the compensation for their services through a third entity such as a personal holding company or a trust located in a country that would not tax the income, while protecting their rights under the treaty when there is a legitimate employer-employee relationship between the performer and the person providing his services. This provision applies notwithstanding the articles governing business profits, income from independent personal services and income from dependent personal services (Article s 7, 15 and 16).

This article is subject to the provisions of the saving clause of paragraph 3 of Article 1 (Personal Scope). Thus, if an entertainer or a sportsman who is resident in Sri Lanka is a citizen of the United States, the United States may tax all of his income from performances in the United States without regard to the provisions of this article, subject, however, to the special foreign tax credit provisions of Article 24 (Relief from Double Taxation). In addition, the benefits of this article are subject to the provisions of Article 23 (Limitation on Benefits).

Article 19. Pensions, Social Security and Child Support Payments

The proposed treaty, like the U.S. model, generally provides that private pensions and other similar remuneration in consideration of past employment paid to a resident of one country may be taxed only in the recipient's country of residence. However, in the case of a citizen of one country who is a resident of the other country, the savings clause of Article 1, paragraph 3, of the proposed treaty provides that, notwithstanding this provision, a country may tax its residents and citizens as if the proposed treaty were not in effect. The Technical Explanation states as an example that a U.S. citizen

who is resident in Sri Lanka and receives a U.S. pension is subject to U.S. net income tax on the payment.

The Technical Explanation states that, in the United States, the payments covered by the general rule of the provision include payments under qualified plans under Code section 401(a), individual retirement plans (including individual retirement plans that are part of a simplified employee pension plan that satisfies Code section 408(k), individual retirement accounts, and section 408(p) accounts), section 457(g) governmental plans, section 403(a) qualified annuity plans, and section 403(b) plans. The Technical Explanation further notes that the competent authorities may agree that payments under other plans that generally meet similar criteria may also benefit under the provision.

This provision of the proposed treaty does not apply to pensions in respect of government service. Rather, such payments generally are covered by Article 20, which provides that pensions paid from the public funds of one county in respect of government service may be taxed only in that country.

The treatment of pensions paid under a Social Security system follows the U.S. model. Pensions paid and other payments made under a Social Security system of one country may be taxed only in that country, notwithstanding the provision relating to private pensions. The provision applies to Social Security payments of either private or government employees.

The proposed treaty also provides that periodic payments for the support of a minor child made pursuant to a written separation agreement or a decree of divorce, separate maintenance or compulsory support, paid by a resident of one country to a resident of the other country, are exempt from tax in both countries.

The saving clause of Article 1 does not apply with respect to the provisions relating to Social Security and child support payments. Thus, as noted in the Technical Explanation, a U.S. citizen who is a resident of Sri Lanka is not subject to U.S. tax on Sri Lanka social security payments or child support payments.

Article 20. Government Service

Under the proposed treaty, remuneration, including a pension, paid by a treaty country (or a political subdivision or local authority thereof) to a citizen or national of that treaty country for services rendered to that country (or subdivision or authority) is taxable only by that country. The provision applies both to government employees and to independent contractors engaged by governments to perform services for them.

The remuneration described in this article is subject to the provisions of this paragraph and not to those of Article s 15 (Independent Personal Services), 16 (Dependent Personal Services), 18 (Artistes and Athletes) or 19 (Pensions, Social Security, and Child Support Payments). If, however, the remuneration is paid for services performed in connection with a business carried on by a treaty country or a political subdivision or local authority thereof, those other articles, and not this article, will apply.

The provisions of this article are exceptions to the proposed treaty's saving clause (Article 1, paragraphs 3 & 4(b)) for individuals who are neither citizens nor permanent residents of the country

where the services are performed. Thus, for example, payments by the government of Sri Lanka to its employees resident in the United States are exempt from U.S. tax if the employees are neither U.S. citizens nor green card holders at the time of payment, regardless of their immigration status at the time they became employed by the Sri Lanka government. Under the U.S. model, such employees would be subject only to U.S. taxation on the non-pension remuneration if resident in the United States at the time they became employed by the Sri Lanka government. Under both the proposed treaty and the U.S. model, U.S. citizens employed in the United States by the government of Sri Lanka are taxable by the United States.

Article 21. Payments to Students and Business Apprentices

The treatment provided to students and business apprentices under the proposed treaty generally corresponds to the provision in the U.S. model, with certain modifications, and is similar to the provision of the OECD model.

Under the proposed treaty, a student or business apprentice who visits a country (the host country) for the primary purpose of his or her full-time education, or for his or her full-time training, and who immediately before that visit is, or was a resident of the other treaty country, generally is exempt from host country tax on payments he or she receives for the purpose of such maintenance, education, or training; provided, however, that such payments arise outside the host country. The Technical Explanation states that for purposes of this article, an individual who visits the host country to receive education or training and who also receives a salary from his or her employer for providing services is not considered a trainee or student and could not claim benefits under this article.

Under the proposed treaty, if an individual from one treaty county visits the other treaty country (the host country) for education or training while an employee of a resident of the first country or as a participant in a program sponsored by the government of the host country or any international organization, the individual is to be exempt from tax in the host country on up to $6,000 of income from personal services. This exemption is limited to one 12 consecutive month period.

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

Article 22. Other Income

This article is a catch-all provision intended to cover items of income not specifically covered in other articles, and to assign the right to tax income from third countries to either the United States or Sri Lanka. As a general rule, items of income not otherwise dealt with in the proposed treaty which are beneficially owned by residents of one of the countries are taxable only in the country of residence. However, this rule is modified to allow the source country a nonexclusive right to tax "other income" arising within the source country. As a result, both the residence country and the source country may tax this income, leaving the resulting double taxation to be resolved under Article 24 (Relief from Double Tax-

ation). This provision is a departure from the U.S. model but is consistent with the U.N. model and with other treaties that the United States has concluded with developing countries.

The Technical Explanation offers the following examples of "other income": gambling winnings, punitive damages, payments for a covenant not to compete, and income from certain financial instruments. The Technical Explanation also notes that the article applies to items of income that are not dealt with because of their source. For example, royalties derived by a resident of one treaty country from a third country are not taxable by the other treaty country under this article.

The Technical Explanation states that under U.S. tax law, partnership and trust income and distributions have the character of the associated distributable net income, and thus generally are covered under other articles of the proposed treaty.

This article is subject to the saving clause, so U.S. citizens who are residents of Sri Lanka will continue to be taxable by the United States on income that is not dealt with elsewhere in the proposed treaty. The benefits of this article are also subject to the provisions of Article 23 (Limitation on Benefits).

Article 23. Limitation on Benefits

In general

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

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

The proposed anti-treaty shopping article provides that a treaty country resident is entitled to all treaty benefits only if it is described in one of several specified categories. Generally, a resident of either country qualifies for the benefits accorded by the proposed treaty if such resident satisfies any other specified conditions for obtaining benefits and falls within one of the following categories of persons:

(1) An individual;
(2) A qualified governmental entity;
(3) A company that satisfies a public company test and certain subsidiaries of such a company;
(4) Certain organizations operated exclusively for religious, charitable, educational, scientific, or other similar purposes;
(5) Certain entities that provide pension or other similar benefits to employees pursuant to a plan and that meet an ownership test; and
(6) An entity that satisfies an ownership test and a base erosion test.

Alternatively, a resident that does not fit into any of the above categories may claim treaty benefits with respect to certain items of income under an active business test. In addition, a person that does not satisfy any of the above requirements, including the active business test, may be entitled to the benefits of the proposed treaty if the source country's competent authority so determines.

Individuals

Under the proposed treaty, individual residents of one of the countries are entitled to all treaty benefits.

Qualified governmental entities

Under the proposed treaty, a qualified governmental entity (defined under Article 3 (General Definitions)) is entitled to all treaty benefits. Generally, qualified governmental entities include the two countries, their political subdivisions or their local authorities, and certain government-owned entities.

Public company tests

A company that is a resident of Sri Lanka or the United States is entitled to treaty benefits if all the shares in the class or classes of shares representing more than 50 percent of the voting power and value of the company are regularly traded on a recognized stock exchange. Thus, such a company is entitled to the benefits of the treaty regardless of where its actual owners reside.

In addition, a company that is a resident of Sri Lanka or the United States is entitled to treaty benefits if at least 50 percent of each class of shares in the company is owned (directly or indirectly) by companies that satisfy the test described in the paragraph above, provided that each intermediate owner used to satisfy the control requirement is entitled to treaty benefits under one of the six categories enumerated above (i.e., an individual; qualified governmental entities; a company that satisfies a public company test and certain subsidiaries of such a company; certain organizations operated exclusively for religious, charitable, educational, scientific, or other similar purposes; certain entities that provide pension or other similar benefits to employees pursuant to a plan and that meet an ownership test; or and an entity that satisfies an ownership test and a base erosion test).

The term "recognized stock exchange" means the NASDAQ; any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Secu-

rities Exchange Act of 1934; the Colombo Stock Exchange; and any other stock exchange agreed upon by the competent authorities of the two countries.

The proposed treaty is silent as to when shares are considered "regularly traded," and in accord with Article 3 (General Definitions), the term will be defined under the domestic laws of the two countries. The Technical Explanation states that for U.S. tax purposes the term is to have the meaning it has under Treas. Reg. sec. 1.884–5(d)(4)(i)(B).[13] Under this regulation, a class of shares is considered to be "regularly traded" if two requirements are met: (1) trades in the class of shares are made in more than de minimis quantities on at least 60 days during the taxable year, and (2) the aggregate number of shares in the class traded during the year is at least 10 percent of the average number of shares outstanding during the year.

Charitable organizations

Under the proposed treaty an entity is entitled to treaty benefits if it is organized under the laws of the United States; generally exempt from tax in the United States; and established exclusively for religious, charitable, educational, scientific, or other similar purposes.

Pension funds

An entity is entitled to treaty benefits under the proposed treaty if it is organized under the laws of the United States; generally exempt from tax in the United States; established to provide pensions or other similar benefits to employees pursuant to a plan; and as of the end of the prior taxable year, more than 50 percent of the beneficiaries, members, or participants are individuals who are residents of one of the countries.

Ownership and base erosion tests

Under the proposed treaty, an entity that is a resident of one of the countries is entitled to treaty benefits if it satisfies an ownership test and a base erosion test. Under the ownership test, on at least half the days of the taxable year, certain categories of persons listed above (i.e., individuals, qualified governmental entities; companies that meet the public company test described above and certain subsidiaries of such companies; certain organizations operated exclusively for religious, charitable, educational, scientific, or other similar purposes; or certain entities that provide pension or other similar benefits to employees pursuant to a plan and that meet an ownership test) must own (directly or indirectly) at least 50 percent of each class of shares or other beneficial interests in the entity. Each intermediate owner used to satisfy the control requirement must be entitled to treaty benefits under one of the six categories of persons enumerated above (i.e., individuals, qualified governmental entities; companies that meet the public company test described above and certain subsidiaries of such companies; certain organizations operated exclusively for religious, charitable, edu-

[13] The Technical Explanation specifically states that Treas. Reg. sec. 1.884–5(d)(4)(i)(A), (ii) and (iii) will not be taken into account for purposes of defining the term "regularly traded" under the proposed treaty.

cational, scientific, or other similar purposes; or certain entities that provide pension or other similar benefits to employees pursuant to a plan if they meet an ownership test described above; or an entity that satisfies an ownership test and a base erosion test).

The base erosion test is satisfied only if less than 50 percent of the person's gross income for the taxable period is paid or accrued (directly or indirectly) in the form of deductible payments to persons who are not residents of either treaty country, unless the payment is attributable to a permanent establishment in either country. The term "gross income" is not defined in the proposed treaty. In accord with Article 3 (General Definitions) of the proposed treaty, the term will be defined under the domestic laws of the two countries. With respect to the United States, the Technical Explanation states that the term will be defined as gross receipts less cost of goods sold. The Technical Explanation further states that deductible payments do not include arm's-length payments in the ordinary course of business for services or tangible property and payments in respect of financial obligations to banks that are residents of one of the two countries or that have a permanent establishment in one of the two countries. However, the Technical Explanation explains that trust distributions are deductible payments to the extent they are deductible from the taxable base.

The Technical Explanation also states that trusts may be entitled to the benefits of this provision if they are treated as residents of one of the countries and they otherwise satisfy the requirements of the provision.

Active business test

Under the active business test, a resident of one of the countries is entitled to treaty benefits with respect to income derived from the other country if (1) the resident is engaged in the active conduct of a trade or business in its residence country, (2) the income is derived in connection with, or is incidental to, that trade or business, and (3) the trade or business is substantial in relation to the trade or business activity in the other country. The proposed treaty provides that the business of making or managing investments for the resident's own account does not constitute an active trade or business unless these activities are banking, insurance, or securities activities carried on by a bank, insurance company, or registered securities dealer.

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

The proposed treaty provides that income is "incidental" to a trade or business if it facilitates the conduct of the trade or business in the other country. The Technical Explanation states that an example of such "incidental" income is interest income earned from the short-term investment of working capital derived from a trade or business.

The proposed treaty provides that whether a trade or business is substantial is determined on the basis of all the facts and circumstances. The Technical Explanation states that this takes into account the comparative sizes of the trades or businesses in each country (measured by reference to asset values, income, and payroll expenses), the nature of the activities performed in each country, and the relative contributions made to that trade or business in each country. The Technical Explanation further states that in making each determination or comparison, due regard will be given to the relative sizes of the U.S. and Sri Lankan economies.

Following the U.S. model, the proposed treaty provides a safe harbor under which a trade or business will be deemed to be substantial if: (1) for the preceding taxable year or the average of the three preceding taxable years, the asset value, the gross income, and the payroll expense that are related to the trade or business in the country of residence equals at least 7.5 percent of the resident's (and any related parties') proportionate share of the asset value, gross income, and payroll expense, respectively, that are related to the activity that generated the income in the other country; and (2) the average of the three ratios exceeds 10 percent. This safe harbor is found in the U.S. model. The Technical Explanation states that if the person from whom the income in the other country is derived is not wholly-owned by the recipient (and parties related thereto), the items included in the computation with respect to such person must be reduced by a percentage equal to the percentage control held by persons not related to the recipient.

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

The term "value" is also not defined in the proposed treaty. Thus, the term will also have the meaning that the term would have under the laws of the country applying the proposed treaty. The Technical Explanation states that "value" generally will be defined for U.S. purposes using the method used by the taxpayer in keeping its books for purposes of financial reporting in its country of residence.

Grant of treaty benefits by the competent authority

The proposed treaty provides a "safety valve" for a person 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. Consequently, a resident of one of the countries who is not otherwise entitled to benefits under the proposed treaty may be granted

benefits if the competent authority of the country from which benefits are claimed so determines.

Article 24. Relief From Double Taxation

Internal taxation rules

United States

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

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.

Sri Lanka

In the absence of a tax treaty, Sri Lanka generally provides unilateral double tax relief by allowing a deduction of foreign taxes against foreign income.

Proposed treaty limitations on internal law

Overview

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

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 Sri Lanka

and the United States otherwise still tax the same item of income. This article is not subject to the saving clause; therefore the country of citizenship or residence will waive its overriding taxing jurisdiction to the extent that this article applies. For example, as more fully discussed below, Sri Lanka is required to provide a foreign tax credit for U.S. taxes paid or deemed paid by its citizens and residents.

Proposed treaty restrictions on U.S. internal law

The proposed treaty generally provides that the United States will allow a U.S. citizen or resident a foreign tax credit for the income taxes imposed by Sri Lanka. The proposed treaty also requires the United States to allow a deemed-paid credit with respect to Sri Lankan income tax, consistent with Code section 902, to any U.S. company that receives dividends from a Sri Lankan company if the U.S. company owns 10 percent or more of the voting stock of such Sri Lankan company. The credit generally is to be computed in accordance with the provisions and subject to the limitations of U.S. law in effect at the time a credit is given (as such law may be amended from time to time without changing the general principles of the proposed treaty provisions). For example, U.S. statutory law governs the foreign tax credit limitations imposed under Code section 904, the relevant currency translation rules, and the carryover periods for excess credits. This provision is similar to those found in the U.S. model and many U.S. treaties.

The proposed treaty provides that the taxes referred to in paragraphs 2(a) and 3 of Article 2 will be considered creditable income taxes for purposes of the U.S. foreign tax credit.

The proposed treaty provides that taxes paid to Sri Lanka by a company resident in Sri Lanka on a distribution or remittance of dividends will be regarded as a tax on the shareholder for purposes of the credit allowed by the United States.

The proposed treaty requires that Sri Lanka shall allow its residents a credit against Sri Lankan tax for taxes paid to the United States. The proposed treaty also requires Sri Lanka to allow a deemed-paid credit to any Sri Lankan company that receives dividends from a U.S.-resident corporation if the Sri Lankan company owns 10 percent or more of the voting stock. The amount of the deemed-paid credit is the amount of U.S. tax paid by the U.S. corporation on the profits out of which the dividends are considered paid. The direct and indirect credits are subject to the provisions and limitations of Sri Lankan law as it may be amended from time to time, without changing the general principle of allowing the credits.

The proposed treaty provides that the taxes referred to in paragraphs 2(b) and 3 of Article 2 will be considered creditable income taxes for purposes of the Sri Lankan foreign tax credit. This includes U.S. Federal income taxes, but excludes the accumulated earnings tax and the personal holding company tax.[14]

The proposed treaty contains a re-sourcing rule for purposes of allowing relief from double taxation under this article. Income derived by a resident of a treaty country which may be taxed in the

[14] Social Security taxes (which are non-income taxes) are also expressly excluded.

other treaty country (other than solely by reason of citizenship in accordance with the savings clause of paragraph 3 of Article 1 (Personal Scope)) is deemed to arise in the other treaty country. However, the Technical Explanation states that domestic law rules that apply for purposes of limiting the foreign tax credit will govern if they differ from the treaty source rules. For example, the United States may apply the rules of Code section 904(g) to treat certain income taxed in Sri Lanka as U.S. source.

Article 25. Non-Discrimination

The proposed treaty contains a comprehensive non-discrimination article. It is similar to the non-discrimination article in the U.S. model and to provisions that have been included in other recent U.S. income tax treaties.

In general, under the proposed treaty, one country cannot discriminate by imposing more burdensome taxes on nationals of the other country than it would impose on its own comparably situated nationals in the same circumstances.[15] Not all instances of differential treatment are discriminatory. Differential treatment is permissible in some instances under this rule on the basis of tax-relevant differences (e.g., the fact that one person is subject to worldwide taxation in a contracting state and another person is not, or the fact that an item of income may be taxed at a later date in one person's hands but not in another person's hands).

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 enterprises carrying on the same activities. Similar to 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 that are granted to its own residents or nationals.

Subject to the anti-avoidance rules described in paragraph 1 of Article 9 (Associated Enterprises), paragraph 7 of Article 11 (Interest), and paragraph 7 of Article 12 (Royalties), each treaty country is required to allow its residents to deduct interest, royalties, and other disbursements paid by them to residents of the other country under the same conditions that it allows deductions for such amounts paid to residents of the same country as the payor. The Technical Explanation states that the term "other disbursements" is understood to include a reasonable allocation of executive and general administrative expenses, research and development expenses, and other expenses incurred for the benefit of a group of related persons that includes the person incurring the expense. The Technical Explanation further states that the exception with respect to paragraph 7 of Article 11 (Interest) would include the denial or deferral of certain interest deductions under section 163(j) of the Code, thus preserving for the United States the ability to apply its earnings stripping rules.

In addition, any debts of a resident of one treaty country to a resident of the other treaty country shall, for purposes of deter-

[15] A national of a contracting state may claim protection under this article even if the national is not a resident of either contracting state. For example, a U.S. citizen who is resident in a third country is entitled to the same treatment in Sri Lanka as a comparably situated Sri Lankan national.

mining the taxable capital of the obligor, be deductible under the same conditions as if they had been owed to a resident of the same treaty country.

The non-discrimination rules also apply to enterprises of one country that are owned in whole or in part by residents of the other country. Enterprises resident in one country, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other country, will not be subjected in the first country to any taxation (or any connected requirement) that is more burdensome than the taxation (or connected requirements) that the first country imposes or may impose on other similar enterprises. As noted above, some differences in treatment may be justified on the basis of tax-relevant differences in circumstances between two enterprises. In this regard, the Technical Explanation provides examples of Code provisions that are understood by the two countries not to violate the nondiscrimination provision of the proposed treaty, including the rules that tax U.S. corporations making certain distributions to foreign shareholders in what would otherwise be nonrecognition transactions, the rules that impose a withholding tax on non-U.S. partners of a partnership, and the rules that prevent foreign persons from owning stock in subchapter S corporations.

The proposed treaty provides that nothing in the non-discrimination article may be construed as preventing either of the countries from imposing branch taxes as described in Article 12A (Branch Tax).

In addition, notwithstanding the definition of taxes covered in Article 2 (Taxes Covered), this article applies, in the case of the United States, to taxes of every kind imposed at the national level, and in the case of Sri Lanka, to all taxes administered by the Commissioner-General of Internal Revenue. The Technical Explanation states that customs duties are not regarded as taxes for this purpose.

The saving clause does not apply to the non-discrimination article. Thus, a U.S. citizen who is resident in Sri Lanka may claim benefits with respect to the United States under this article.

Article 26. Mutual Agreement Procedure

The proposed treaty contains the standard mutual agreement provision, with some variation, that authorizes the competent authorities of the two countries to consult together to attempt to alleviate individual cases of double taxation not in accordance with the proposed treaty.

Under this article, a person who considers that the action of one or both of the countries cause him or her to be subject to tax which is not in accordance with the provisions of the proposed treaty may (irrespective of internal law remedies) present his or her case to the competent authority of the country in which he or she is a resident or a national.

The proposed treaty provides that if the objection appears to be justified and that competent authority is not itself able to arrive at a satisfactory solution, that competent authority must endeavor to resolve the case by mutual agreement with the competent authority of the other country, with a view to the avoidance of taxation

which is not in accordance with the proposed treaty. The proposed treaty provides that any agreement reached will be implemented notwithstanding any time limits or other procedural limitations under the domestic laws of either country (e.g., a country's applicable 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 proposed treaty. In particular, the competent authorities may agree to: (1) the same attribution of income, deductions, credits, or allowances of an enterprise of one treaty country to the enterprise's permanent establishment situated in the other country; (2) the same allocation of income, deductions, credits, or allowances between persons; (3) the same characterization of particular items of income; (4) the same application of source rules with respect to particular items of income; (5) a common meaning of a term; (6) increases in any "specific amounts"[16] referred to in the proposed treaty to reflect economic or monetary developments; and (7) the application of the provisions of each country's domestic law regarding penalties, fines, and interest in a manner consistent with the purposes of the proposed treaty. The Technical Explanation clarifies that this list is a non-exhaustive list of examples of the kinds of matters about which the competent authorities may reach agreement.

The proposed treaty provides that the competent authorities may consult together for the elimination of double taxation regarding cases not provided for in the proposed treaty.

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

The Technical Explanation states that the provisions of Article 26 (Mutual Agreement Procedure) of the proposed treaty will have effect from the date of entry into force of the proposed treaty, without regard to the taxable or chargeable period to which the matter relates.

Article 27. Exchange of Information and Administrative Assistance

The proposed treaty provides that the two competent authorities will exchange such information as is necessary[17] to carry out the provisions of the proposed treaty, or the domestic laws of the two countries concerning all national taxes[18] insofar as the taxation thereunder is not contrary to the proposed treaty, as well as to pre-

[16] The Technical Explanation states that this term refers to specific dollar amounts referred to in the proposed treaty, such as the $6,000 exemptions for artistes and athletes (Article 18) and for students and trainees (Article 21). The Technical Explanation states that this term does not encompass percentage amounts specified in the proposed treaty.

[17] The U.S. model uses "relevant" instead of "necessary." The Technical Explanation states that "necessary" has been consistently interpreted as being equivalent to "relevant," and does not necessitate a demonstration that a State would be prevented from enforcing its tax laws absent the information.

[18] Paragraph 6 of this article states that notwithstanding the provisions of Article 2 (Taxes Covered), this article applies to taxes of every kind imposed at the national level of the United States and all taxes administered by the Commissioner-General of Inland Revenue of Sri Lanka.

vent fiscal evasion. Although "fiscal evasion" is not defined in either the proposed treaty or the Technical Explanation, it appears to encompass both civil and criminal tax evasion or fraud as well as non-tax offenses, such as securities law violations. It also encompasses facilitating the administration of statutory provisions against legal avoidance.

This exchange of information is not restricted by Article 1 (Personal Scope). Therefore, information with respect to third-country residents is covered by these procedures. The two competent authorities may exchange information on a routine basis, on request in relation to a specific case, or spontaneously. The Technical Explanation states that it is contemplated that all of these types of exchange will be utilized, as appropriate.

Any information exchanged under the proposed treaty is treated as secret in the same manner as information obtained under the domestic laws of the country receiving the information. The exchanged information may be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes to which the proposed treaty applies. Such persons or authorities must use the information for such purposes only. Exchanged information may be disclosed in public court proceedings or in judicial decisions.

Unlike the U.S. model and unlike virtually all recent U.S. tax treaties, the proposed treaty does not contain a provision permitting disclosure of exchanged information to persons or authorities engaged in the oversight of the tax system (e.g., the tax-writing committees of Congress and the General Accounting Office). This lacuna could present a serious impediment to legislative branch oversight of the operation of the proposed treaty. The Committee may wish to consider whether the Senate should enter into an understanding as part of the ratification process permitting disclosure of exchanged information to persons or authorities engaged in the oversight of the tax system.

If information is requested by a country in accordance with this article, the proposed treaty provides that the other country will obtain that information in the same manner and to the same extent as if the tax of the requesting country were the tax of the other country and were being imposed by that country, notwithstanding that such other country may not need such information at that time.

The proposed treaty provides that if specifically requested by the competent authority of a country, the competent authority of the other country must provide information under this article in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of the requested country with respect to its own taxes.

As is true under the U.S. model and the OECD model, under the proposed treaty, a country is not required to carry out administrative measures at variance with the laws and administrative prac-

tice of either country, to supply information that is not obtainable under the laws or in the normal course of the administration of either country, or to supply information that would disclose any trade, business, industrial, commercial, or professional secret or trade process or information, the disclosure of which would be contrary to public policy.

The notes provide that the powers of each country's competent authority to obtain information include the ability to obtain information held by financial institutions, nominees, or persons acting in an agency or fiduciary capacity. This does not include the ability to obtain information that would reveal confidential communications between a client and an attorney, where the client seeks legal advice. The Technical Explanation states that, in the case of the United States, the scope of the privilege for such confidential communications is coextensive with the attorney-client privilege under U.S. law. The notes also provide that the competent authorities may obtain information relating to the ownership of legal persons. The notes confirm that each country's competent authority is able to exchange such information in accordance with this article.

Under the proposed treaty, a country may collect on behalf of the other country such amounts as may be necessary to ensure that relief granted under the treaty by the other country does not inure to the benefit of persons not entitled thereto. However, neither country is obligated to carry out administrative measures that would be contrary to its sovereignty, security, or public policy.

The Technical Explanation states that the provisions of Article 27 (Exchange of Information and Administrative Assistance) of the proposed treaty will have effect from the date of entry into force of the proposed treaty, without regard to the taxable or chargeable period to which the matter relates.

Article 28. Members of Diplomatic Missions and Consular Posts

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

Article 29. Entry Into Force

The proposed treaty provides that the treaty is subject to ratification in accordance with the applicable procedures of each country, and that instruments of ratification will be exchanged as soon as possible. The proposed treaty will enter into force upon the exchange of instruments of ratification.

With respect to each country, the proposed treaty will be effective with respect to taxes withheld at source for amounts paid or cred-

ited on or after the first day of the second month following the date on which the proposed treaty enters into force. With respect to other taxes, the proposed treaty will be effective for taxable periods beginning on or after the first day of January of the year in which the proposed treaty enters into force. The effective date of the proposed treaty with respect to other taxes differs from the U.S. model and most U.S. tax treaties, which provide an effective date with respect to other taxes of the first day of January next following the date of entry into force.

The Technical Explanation states that the provisions of Article 26 (Mutual Agreement Procedure) and Article 27 (Exchange of Information) of the proposed treaty will have effect from the date of entry into force of the proposed treaty, without regard to the taxable or chargeable period to which the matter relates.

Article 30. Termination

The proposed treaty will remain in force until terminated by either country. Either country may terminate the proposed treaty, after the expiration of a period of five years from the date of its entry into force, by giving six months prior written notice of termination to the other country through diplomatic channels. In such case, with respect to each treaty country, a termination is effective with respect to taxes withheld at source for amounts paid or credited on or after the first day of January next following the expiration of the six-month period following notice of termination. With respect to other taxes, a termination is effective for taxable periods beginning on or after the first day of January next following the expiration of the six-month period following notice of termination.

V. ISSUES

A. Stability of Sri Lankan Law

Political stability and tax treaties

In the past the Treasury Department has maintained that a country's political situation should be a factor in determining whether to build stronger economic ties with that country. In a July 5, 1995, letter to the Senate Foreign Relations Committee the Treasury Department wrote:

> A country's political situation is a factor that is considered in determining whether to build stronger economic ties with that country. When consideration of this and other factors leads to a policy of building stronger economic ties with a particular country, a tax treaty becomes a logical part of that policy. One of a treaty's main purposes is to foster the competitiveness of U.S. firms that enter the treaty partner's market place. As long as it is U.S. policy to encourage U.S. firms to compete in these market places, it is in the interest of the United States to enter tax treaties.
>
> Moreover, in countries where an unstable political climate may result in rapid and unforeseen changes in economic and fiscal policy, a tax treaty can be especially valuable to U.S. companies, as the tax treaty may restrain the government from taking actions that would adversely impact U.S. firms, and provide a forum to air grievances that otherwise would be unavailable.[19]

Background of political developments in Sri Lanka

The government of Sri Lanka is a constitutional democracy.[20] For approximately the past 20 years, the country has experienced periods of significant conflict involving a separatist group that has been declared by the United States to be a terrorist organization. In recent years the Norwegian government has facilitated a peace process designed to resolve this conflict. In November 2003, while the Sri Lankan prime minister was in Washington seeking support for the peace process, the Sri Lankan president removed three cabinet ministers, suspended parliament, and imposed martial law. In

[19] This quote appears in the Report of the Senate Foreign Relations Committee on the Income Tax Convention with Ukraine, Exec. Rept. 104–5, August 10, 1995, regarding an issue that was raised with respect to that treaty in connection with the stability of the Ukrainian tax law.

[20] Congressional Research Service, Sri Lanka: Background and U.S. Relations, November 5, 2003 (RL31707).

February 2004,[21] the Sri Lankan president dissolved parliament and set April 2, 2004 for the next general election.[22]

The State Department has recently stated that Sri Lanka currently is experiencing a "domestic political crisis." The full text of the State Department statement follows.

> *Sri Lanka: Deputy Secretary Armitage's Meeting With Minister For Economic Reform, Science, And Technology Milinda Moragoda*
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> Deputy Secretary Armitage met today, December 29, with Sri Lankan Minister for Economic Reform, Science, and Technology Milinda Moragoda to discuss the full range of bilateral issues, including the peace process. During their meeting, the Deputy Secretary told Minister Moragoda that the United States maintains a strong interest in Sri Lanka finding a resolution to its 20-year civil conflict. Mr. Armitage said that the current domestic political crisis, precipitated in Colombo during the Prime Minister's Washington visit, will have a negative impact on the peace process until a clarification of responsibilities that would allow the Prime Minister to resume peace negotiations can be found.
>
> The Deputy Secretary said the current political impasse in Sri Lanka cannot be allowed to continue, and added that he will consult with the other donor co-chairs—Norway, Japan, and the European Union—to define a way forward after taking stock of the situation.
>
> The United States stands behind Sri Lanka in its search for peace and looks forward to an early resumption of negotiations between the government and the Liberation Tigers of Tamil Eelam to end nearly 20 years of conflict.

Issues

Several issues arise in the consideration of a tax treaty with a government that is experiencing political instability. One is that it may be difficult to identify correctly the other country's competent authority in situations where there are competing claims as to who is authorized to exercise legislative, executive, or judicial authority. Another issue is the extent to which any political instability also causes uncertainty as to the precise nature of the substantive law of that country. These uncertainties may make it difficult to administer the treaty.

A more specific issue arises in the context of the exchange of information provisions of the proposed treaty (Article 27 of the proposed treaty). The exchange of information provision requires that information that is exchanged shall be treated as secret by the receiving country in the same manner as information obtained under its local laws and may only be disclosed to persons involved in the assessment, collection, or administration of taxes covered by the provision. Several issues may arise with respect to the utilization of this provision with a government that is experiencing political

[21] This description summarizes reported events through February 10, 2004.
[22] New York Times, February 9, 2004, page A5.

instability. First, it may be more difficult to assess whether confidentiality will be respected when the information is initially exchanged. Second, it may be more difficult to assess the possibility that inappropriate use will be made in the future of the exchanged information. Third, the country receiving the information could weaken (or potentially eliminate) the confidentiality protections under its local laws, which would concomitantly weaken or eliminate those protections for exchanged information.

The issues involving the exchange of information provisions, while serious, may be dealt with by the United States competent authority in administering the provisions of the proposed treaty. In general, the United States competent authority meets with another country's competent authority prior to the actual exchange of information so that (among other purposes) the United States competent authority is satisfied that the confidentiality provisions will be observed. The Joint Committee staff understands that the United States competent authority has suspended exchanging information (or has not begun to exchange information) with countries with respect to which the United States competent authority has been dissatisfied with the other country's compliance with the confidentiality provisions.

The Committee may wish to consider the implications of this political instability on the proposed treaty. Some might argue that, in light of the instability, it might be prudent to consider delaying consideration of ratification. Others might respond that the United States has tax treaties with other countries that have also experienced political instability, so that should not be a disqualifying factor. In addition, the proposed treaty would provide benefits (as well as certainty) to taxpayers who have no choice but to live through the period of political instability; some would argue that these taxpayers should not be denied the benefits of the treaty. The Committee may wish to consider the benefits provided under the proposed treaty as well as the concerns over political instability.

B. Sri Lankan Tax Law as Reflected in the Proposed Treaty

A tax treaty modifies the internal tax laws of both treaty partners. The interaction between the countries' internal tax law provisions and treaty provisions is typically quite complex and may significantly affect the treaty negotiations. The Department of the Treasury's Preamble to the Technical Explanation of the U.S. model discusses the importance of understanding the tax laws of a U.S. treaty partner as follows:

> The United States would not negotiate a treaty with a country without thoroughly analyzing the tax laws and administrative practices of the other country.
>
> * * * * *
>
> Therefore, variations from the Model text in a particular case may represent a modification that the United States views as necessary to address a particular aspect of the treaty partner's tax law, or even represent a substantive concession by the treaty partner in favor of the United States. * * * Consequently, it would not be appropriate to base an evaluation of an actual treaty simply on the number of differences between the treaty and the Model. Rather, such an evaluation must be based on a firm understanding of the treaty partner's tax laws and policies, how that law interacts with the treaty and the provisions of U.S. tax law, precedents in the partner's other treaties, the relative economic positions of the two treaty partners, the considerations that gave rise to the negotiations, and the numerous other considerations that give rise to any agreement between two sovereign nations.

The issue raised under the proposed treaty is whether Sri Lanka's current tax laws and policies were fully considered in treaty negotiations. In that context, it is not clear that recent changes in the Sri Lankan internal tax laws have been fully taken into account in the proposed treaty and protocol.[23]

The proposed protocol, signed on September 20, 2002, does not generally appear to address changes that have occurred in the Sri Lankan tax laws since the proposed treaty was initially signed in 1985.[24] Several of the articles of the proposed treaty contain provisions that are less favorable to taxpayers than the corresponding rules of the internal Sri Lankan tax laws. For example, the maximum permissible withholding rate for dividends paid to nonresidents of Sri Lanka under the proposed treaty is 15 percent, while the internal Sri Lankan tax law currently provides for a 10

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[23] The information discussed in this pamphlet relating to Sri Lankan tax law (and the analysis of such information) is based on the Joint Committee staff's review of publicly available secondary sources and comments from the government of Sri Lanka. *See* section III of this pamphlet for an overview description of Sri Lankan tax law. Accordingly, the details in such description may not be fully accurate in all respects, as many details have been omitted and simplifying generalizations made for ease of exposition.

[24] Changes in the U.S. tax laws were taken into account in the proposed treaty. The Letter of Submittal from the Secretary of State to the President states that "[m]any provisions of the proposed Protocol updates relate to amendments to the U.S. Internal Revenue Code that have occurred since the Convention was signed in 1985. * * * Most other provisions of the proposed Protocol update the language of the Convention to account for changes in U.S. treaty policy that have occurred since the Convention was signed."

percent withholding rate.[25] Article 1, paragraph 2 of the proposed treaty provides that the proposed treaty shall not restrict any benefit provided under domestic law of a treaty country. Consequently, the applicable withholding rate is 10 percent. Under Article 1, paragraph 2, Sri Lanka may change its internal tax law to raise the withholding rate up to the limit provided under the proposed treaty, i.e., 15 percent. It is not necessarily inappropriate to provide a maximum withholding tax rate in a treaty that is higher than the treaty country's corresponding internal law rate, but it is not clear if or how this difference impacted the treaty negotiations leading to the proposed protocol.

There are other changes in the Sri Lankan internal tax laws in recent years that may not have been taken into account in the proposed treaty and protocol. These include branch tax (Article 12A, subparagraph 2(b)(i)), which is generally imposed at 10 percent as a remittance tax under the internal Sri Lankan tax laws, but which is limited to 15 percent under the proposed treaty and protocol, and capital gains tax, which was repealed effective April 1, 2002 under the internal Sri Lanka tax laws, but which is currently (generally) limited under the proposed treaty to residents of Sri Lanka.[26] In addition, Article 2, paragraph 2(a), states that the income tax based on the turnover of enterprises licensed by the Greater Colombo Economic Commission is a covered tax under the proposed treaty. However, it appears that Sri Lanka replaced such tax in 1998 with a new Goods and Services Tax, which in turn was replaced in 2002 with a new Value Added Tax.[27]

These and possibly other Sri Lanka internal tax law changes call into question the extent to which the proposed treaty appropriately takes into account the current internal tax laws of Sri Lanka. Rather than modifying the current internal tax laws of Sri Lanka, some of the provisions of the proposed treaty may have merely provided a ceiling for future changes to such laws, while other treaty provisions may be addressing Sri Lankan taxes that no longer exist.

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[25] The dividend withholding rate appears to have been modified to 10 percent in April 2002. See Asia-Pacific Taxation Analysis, Sri Lanka, Dividends, Chapter 13.7.6 and "Budget 2002/03" (Supp. No. 219), published by International Bureau of Fiscal Documentation.

[26] Under the 2004 proposed Budget, effective April 1, 2004, it is proposed that profits from the sale of shares by any person (subject to certain exemptions) will be taxed at 15 percent.

[27] *See* Asia-Pacific Taxation Analysis, Sri Lanka, Other Taxes on Goods and Services, Chapter 43.1, and "VAT Regime Enters into Effect" (Supp. No. 219), published by International Bureau of Fiscal Documentation.

C. Developing-Country Concessions

In general

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

Definition of permanent establishment

The proposed treaty departs from the U.S. model by providing for relatively broad source-basis taxation. In particular, the proposed treaty's permanent establishment article permits the country in which business activities are performed to tax these activities in a broader range of circumstances than would be permitted under the U.S. model.

For example, under the proposed treaty, a building site, a construction or assembly project, or an installation or drilling rig or ship used for the exploration of natural resources constitutes a permanent establishment if such project, or activity relating to such installation, rig, or ship, as the case may be, continues for more than 183 days—the U.S. model uses a threshold of 12 months. The proposed treaty also provides that the furnishing of services (e.g., consulting services) by an enterprise through employees or other personnel engaged for such purpose constitutes a permanent establishment if the activity continues within the country for an aggregate of more than 183 days in any 12-month period—the U.S. model provides that these activities give rise to a permanent establishment only if conducted through a fixed place of business or by a dependent agent.

In addition, the proposed treaty provides that, except in the case of reinsurance, an insurance enterprise of one treaty country will be deemed to have a permanent establishment in the other treaty country if it collects premiums or insures risks situated in the other treaty country through a person other than an independent agent. The proposed treaty also provides that if the activities of an agent are devoted wholly or almost wholly on behalf of an enterprise, and the transactions between the enterprise and the agent do not conform to arm's-length conditions, then the agent may cause the enterprise to have a permanent establishment in the country in which the agent's activities are performed. In addition, the proposed treaty provides that if a dependent agent maintains in one treaty country a stock of goods or merchandise from which the agent regularly fills orders or makes deliveries on behalf of an enterprise of the other treaty country, and additional activities conducted in the source country on behalf of the enterprise have contributed to the conclusion of the sale of such goods or merchandise, then the enterprise is deemed to have a permanent establishment in the source country. These provisions all expand source-basis taxation beyond what is provided in the U.S. model.

Taxation of business profits

The proposed treaty does not permit a permanent establishment to deduct payments that it makes to the head office, or any other

office, of the enterprise that includes the permanent establishment if such payments constitute: (1) royalties, fees or other similar payments in return for the use of patents, know-how or other rights; (2) commissions or other charges for specific services performed or for management; or (3) interest on loans to the permanent establishment. Similarly, such payments made to the permanent establishment by the head office or other office of the enterprise that includes the permanent establishment are not taken into account in determining the taxable business profits of the permanent establishment. This rule is a departure from the U.S. model.

Other concessions to source-basis taxation

In several instances, the proposed treaty allows higher rates of source-country tax than the U.S. model allows. The proposed treaty allows a maximum rate of source-country tax of 15 percent on dividends, which is consistent with the U.S. model, but it does not reduce this maximum rate to five percent in cases in which the shareholder owns at least 10 percent of the voting stock of the dividend-paying company, as the U.S. model does. The proposed treaty also allows source-country taxation of interest at a maximum rate of 10 percent, whereas the U.S. model generally does not permit source-country taxation of interest. Similarly, the proposed treaty allows source-country taxation of royalties at a maximum rate of 10 percent and certain equipment rentals at a maximum rate of five percent, whereas the U.S. model generally does not permit source-country taxation of such royalties and rental fees. The proposed treaty also allows the source country a non-exclusive right to tax "other income" (i.e., income not specifically dealt with in other provisions of the treaty), whereas the U.S. model provides for exclusive residence-based taxation of such income.

In addition, the proposed treaty permits source-country taxation of income derived by a resident of the other treaty country from the performance of independent personal services if the resident is present in the source country for a total of more than 183 days during any 12–month period, even if such income is not attributable to a fixed base or permanent establishment, as the U.S. model would require.

Grants

The proposed treaty includes a provision providing favorable treatment for grants received by a U.S. resident company from the government of Sri Lanka for purposes of investment promotion and economic development in Sri Lanka. The provision provides for the exclusion from income and from earnings and profits for U.S. tax purposes of a cash grant or similar payment by the government of Sri Lanka to a U.S. resident in respect of a wholly owned enterprise in Sri Lanka, or to a company resident in Sri Lanka that is wholly owned by a U.S. resident. No similar provision is found in the U.S. model treaty, nor is any similar provision included in any U.S. bilateral tax treaty other than one (the U.S.-Israel treaty).

Issues

One purpose of the proposed treaty is to reduce tax barriers to direct investment by U.S. firms in Sri Lanka. The practical effect

of the developing-country concessions in the proposed treaty could be greater Sri Lankan taxation (or less U.S. taxation) of activities of U.S. firms in Sri Lanka than would be the case under rules comparable to those of either the U.S. model or the OECD model.

Some existing U.S. treaties with developing countries include concessions similar to those in the proposed treaty. The issue is whether these developing-country concessions represent appropriate U.S. treaty policy, and if so, whether Sri Lanka is an appropriate recipient of these concessions. There is a risk that the inclusion of these concessions in the proposed treaty could result in additional pressure on the United States to include such concessions in future treaties negotiated with developing countries. On the other hand, concessions of this kind arguably are necessary in order to conclude tax treaties with developing countries.

Tax treaties with developing countries can be in the interest of the United States because they provide reductions in the taxation by such countries of U.S. investors and a clearer framework for the taxation of U.S. investors. Such treaties also provide dispute-resolution and nondiscrimination rules that benefit U.S. investors, as well as information-exchange procedures that aid in the administration and enforcement of the tax laws.

D. Income From the Rental of Ships and Aircraft

The proposed treaty includes a provision similar to the U.S. model under which income or profits from an enterprise's operation of aircraft in international traffic are taxable only in the enterprise's country of residence. This provision includes income from the rental of aircraft if the lessee operates the aircraft in international traffic *or* if such rental income is incidental to other income of the lessor from the operation of aircraft in international traffic.

However, unlike the U.S. model and many U.S. income tax treaties, the proposed treaty: (1) allows for limited source-country taxation on income from the operation of ships in international traffic, subject to a most-favored-nation provision; and (2) provides that an enterprise that engages only in the *rental* of ships is treated less favorably than an enterprise that engages in the *operation* of ships, except when the most-favored-nation provision is currently applied to income and profits from the full basis leasing of ships.

First, the proposed treaty provides for limited source-country taxation of income from the operation of ships in international traffic. The amount of source-country tax that may be imposed is limited to 50 percent of the amount that would have been imposed in the absence of the proposed treaty. The proposed treaty limits the amount of shipping profits subject to tax in Sri Lanka to the lesser of 50 percent of the amount otherwise due or six percent of the gross receipts from passengers or freight embarked in Sri Lanka. Similarly, the proposed treaty provides that the amount of U.S. tax that may be imposed on income or profits derived by a resident of Sri Lanka from the operation of ships in international traffic shall not exceed 50 percent of the amount which would have been imposed in the absence of the proposed treaty. Thus, the U.S. tax on the income of a Sri Lankan shipping company would be two percent of the company's U.S. source gross transportation income from the operation of ships in international traffic (under section 887 of the Code, the rate is four percent.)

The proposed treaty also provides for limited source-country taxation of incidental income of the lessor from the rental on a full (i.e., with crew) or bareboat (i.e., without crew) basis of ships operated by the lessee in international traffic. The rate of tax imposed by the source country on incidental income from the rental of ships is limited to half the rate of tax applied to royalties under the proposed treaty (i.e., 2.5 percent). Nonincidental profits from *both* full and bareboat leasing of ships would be subject to full source-country taxation.

The provisions that allow for limited source-country taxation of income from the operation of ships in international traffic and limited source-country taxation of incidental income from the rental of ships in international traffic are subject to a most-favored-nation obligation under the proposed treaty. The most-favored-nation obligation provides that the amount of source country tax related to income from the operation of ships in international traffic shall not exceed the amount of Sri Lankan tax that may be imposed on such income derived by a resident of a third country. Both the Technical Explanation and the notes explain that Sri Lanka has agreed to

provide full exemption for "profits from the operation of ships or aircraft in international traffic" in Article 8(1) of the income tax treaty between Sri Lanka and the United Kingdom, and in Article 8(1) of the income tax treaty between Sri Lanka and Poland.[28] Accordingly, Sri Lanka acknowledged in the notes to the proposed treaty that the same exemption for income from the operation of ships in international traffic extends to such income derived by an enterprise of the United States.

Thus, after applying the most-favored-nation obligation, the proposed treaty currently would grant full exemption from source country tax for income from the operation of ships in international traffic, incidental income from the full or bareboat rental of ships and nonincidental income from the full basis rental of ships, when such ships are operated by the lessee in international traffic. This would not be the case if the Sri Lankan income tax treaties with the United Kingdom and Poland were amended or terminated. The Committee may wish to consider whether the proposed treaty's rules treating the income or profits from the operation of ships in international traffic less favorably than the income from the operation of aircraft in international traffic by allowing for certain source country taxation, except pursuant to a most-favored-nation obligation, are appropriate.

Second, the U.S. model and many other treaties provide that income or profits from the rental of ships and aircraft operated in international traffic on a full or bareboat basis are taxable only in the country of residence, without requiring that the rental income or profits be incidental to other income or profits of the lessor. Under the proposed treaty, income or profits from the rental of ships on a full or bareboat basis are provided a reduced rate of source-country tax (subject to a most-favored-nation provision) only if such rental income or profits are incidental to the lessor. Thus, unlike the U.S. model, the proposed treaty provides that an enterprise that engages only in the rental of ships, but does not engage in the operation of ships, would not receive a reduction of source-country tax (prior to applying to the most-favored-nation provision).

Prior to applying the most-favored-nation provision, nonincidental income and profits from both full and bareboat leasing of ships would be subject to full source-country tax. After applying the most-favored-nation-provision, nonincidental full basis rental income or profits from the leasing of ships would be exempt from source country tax[29] and nonincidental bareboat basis rental income or profits from the leasing of ships would continue to be subject to full source country tax. If the lease is not merely incidental to the international operation of ships by the lessor, then profits from rentals of ships generally would be taxable by the source country as business profits.

The Committee may wish to consider whether the proposed treaty's rules treating income or profits from the rental of ships less fa-

[28] OECD Commentary under paragraph 5 of Article 8 (Shipping, Inland Waterways Transport, and Air Transport) states, "profits obtained by leasing a ship or aircraft on charter fully equipped, manned and supplied must be treated like the profits from the carriage of passengers or cargo. Otherwise, a great deal of business of shipping or air transport would not come within the scope of the provision." Thus, based on OECD Commentary, all income and profits from leases on a *full* basis would be exempt from tax in Sri Lanka.

[29] *Id.*

vorably than income or profits from the operation of ships, are appropriate. The Committee may also wish to consider whether, upon applying the most-favored-nation provision, the proposed treaty's rules treating the income or profits from the bareboat rental of ships less favorably than the income or profits from the full basis rental of ships, are appropriate.

It should be noted that, under the proposed treaty, profits from the use, maintenance, or rental of containers used in international traffic are taxable only in the country of residence, regardless of whether the recipient of such income is engaged in the operation of ships or aircraft in international traffic.

E. Education and Training

Treatment under proposed treaty

Under Article 21 of the proposed treaty, U.S. taxpayers who are visiting Sri Lanka and individuals who immediately prior to visiting the United States were resident in Sri Lanka will be exempt from income tax in the host country on certain payments received if the purpose of their visit is to engage in full-time education or to engage in full-time training. The exempt payments are limited to those payments the individual may receive for his or her maintenance, education or training as long as such payments are from sources outside the host country. In the case of an individual engaged primarily in training or education, but who is an employee of a person resident in his or her home country or who is participating in a program of the government of the host country or of an international organization, a different exemption applies. Such an individual is exempt from host country tax on up to $6,000 of personal service income. The exemption from income tax in the host country applies only for a period of one year or less.

Issues

Full-time students and persons engaged in full-time training

The proposed treaty generally has the effect of exempting payments received for the maintenance, education, and training of full-time students and persons engaged in full-time training as a visitor from the United States to Sri Lanka or as a visitor from Sri Lanka to the United States from the income tax of both the United States and Sri Lanka. This conforms to the U.S. model with respect to students and generally conforms to the OECD model provisions with respect to students and trainees.

This provision generally would have the effect of reducing the cost of such education and training received by visitors. This may encourage individuals in both countries to consider study abroad in the other country. Such cross-border visits by students and trainees may foster the advancement of knowledge and redound to the benefit of residents of both countries.

The proposed treaty applies a different standard when the visiting individual is an employee of a person in his or her home country or participates in a program sponsored by the government of the host country or of an international organization. For such an individual exemption is not provided for payments from outside the host country for maintenance, education, and training, rather for the period of one year, such an individual may exempt up to $6,000 in personal services income from tax in the host country. In this regard the proposed treaty departs from both the U.S. model and the OECD model. The U.S. model limits exemptions for payments of maintenance, education, and training for one year in the case of business trainees but does not provide any exemption related to personal services income. The OECD model does not limit the duration of exemption for payments for maintenance, education, and training for business trainees and does not provide any exemption related to personal services income.

Depending upon the costs of maintenance, education, and training, the dollar value of the exemption to non-employee visitors may be greater than the dollar value of the exemption for employee (or program participant) visitors. By potentially subjecting such payments for maintenance, education, and training as well as all personal services income received to host country income tax in the case of visits by employees or program participants engaged in visits of greater than one year in duration, the cost for such cross-border visitors of engaging in education or training programs of longer duration would be increased. It could be argued that the training or education of an employee relates primarily to specific job skills of value to the individual or the individual's employer rather than enhancing general knowledge and cross-border understanding, as may be the case in the education or training of a non-employee visitor. This could provide a rationale for providing more open-ended treaty benefits in the case of non-employee students and trainees as opposed to employees. However, if employment provides the underlying rationale for disparate treaty benefits, a question might arise as to why training requiring one year or less is preferred to training that requires a longer visit to the host country? As such, the proposed treaty would favor certain types of training arrangements over others. Further, if employment provides the underlying rationale for disparate treaty benefits, why participants in a host country or international organization sponsored program of education or training would be treated like employees is less easily discerned.

Teachers and professors

The proposed treaty is consistent with the U.S. model in which no such exemption would be provided for the remuneration of visiting teachers, professors, or academic researchers. While this is the position of the U.S. model, an exemption for visiting teachers and professors has been included in many bilateral tax treaties. Of the more than 50 bilateral income tax treaties in force, 30 include provisions exempting from host country taxation the income of a visiting individual engaged in teaching or research at an educational institution, and an additional 10 treaties provide a more limited exemption from taxation in the host county for a visiting individual engaged in research. Four of the most recently ratified income tax treaties did contain such a provision.[30] Indeed, the proposed treaty with Japan would provide such an exemption.

The effect of such exemptions for the remuneration of visiting teachers, professors, and academic researchers generally is to make such cross-border visits more attractive financially. Increasing the financial reward may serve to encourage cross-border visits by academics. Such cross-border visits by academics for teaching and research may foster the advancement of knowledge and redound to the benefit of residents of both countries. On the other hand, such an exemption from income tax may be seen as unfair when com-

[30] The treaties with Italy, Slovenia, and Venezuela, each considered in 1999, and the treaty with the United Kingdom considered in 2003, contain provisions exempting the remuneration of visiting teachers and professors from host country income taxation. The treaties with Denmark, Estonia, Latvia, and Lithuania, also considered in 1999, did not contain such an exemption, but did contain a more limited exemption for visiting researchers. However, the protocols with Australia and Mexico, ratified in 2003, did not include such exemptions.

pared to persons engaged in other occupations whose occupation or employment may cause them to relocate temporarily abroad. Such exemptions for remuneration of teachers, professors, and academic researchers could be said to violate the principle of horizontal equity by treating otherwise similarly economically situated taxpayers differently.

The Committee may wish to satisfy itself that the exclusion of such an exemption with respect to Sri Lanka is appropriate. Looking beyond the U.S.-Sri Lanka treaty relationship, the Committee may wish to determine whether the exclusion of an exemption from host country taxation for visiting teachers and professors is consistent with recent trend in U.S. tax treaty policy. Specifically, the Committee may want to know whether the Treasury Department intends to exclude such exemptions in other proposed treaties in the future.[31]

[31] *See* Part V.G of this pamphlet for a discussion of divergence from the U.S. model tax treaty.

F. Disclosure of Information in Connection With Oversight of the Tax System

The proposed treaty provides that the two competent authorities will exchange such information as is necessary to carry out the provisions of the proposed treaty, or the domestic laws of the two countries concerning all national taxes insofar as the taxation thereunder is not contrary to the proposed treaty, as well as to prevent fiscal evasion. Any information exchanged under the proposed treaty is treated as secret in the same manner as information obtained under the domestic laws of the country receiving the information.

The exchanged information may be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes to which the proposed treaty applies. Such persons or authorities must use the information for such purposes only. Exchanged information may be disclosed in public court proceedings or in judicial decisions.

Unlike the U.S. model and unlike virtually all recent U.S. tax treaties, the proposed treaty does not contain a provision permitting disclosure of exchanged information to persons or authorities engaged in the oversight of the tax system (e.g., the tax-writing committees of Congress and the General Accounting Office). This lacuna could present a serious impediment to legislative branch oversight of the operation of the proposed treaty. The Committee may wish to consider whether the Senate should enter into an understanding as part of the ratification process permitting disclosure of exchanged information to persons or authorities engaged in the oversight of the tax system.

G. U.S. Model Tax Treaty Divergence

Background

It has been longstanding practice for the Treasury Department to maintain, and update as necessary, a model income tax treaty that reflects the policies of the United States pertaining to income tax treaties. The current U.S. policies on income tax treaties are contained in the U.S. model. Some of the purposes of the U.S. model are explained by the Treasury Department in its Technical Explanation of the U.S. model:

> [T]he Model is not intended to represent an ideal United States income tax treaty. Rather, a principal function of the Model is to facilitate negotiations by helping the negotiators identify differences between income tax policies in the two countries. In this regard, the Model can be especially valuable with respect to the many countries that are conversant with the OECD Model. * * * Another purpose of the Model and the Technical Explanation is to provide a basic explanation of U.S. treaty policy for all interested parties, regardless of whether they are prospective treaty partners.[32]

U.S. model tax treaties provide a framework for U.S. treaty policy. These models provide helpful information to taxpayers, the Congress, and foreign governments as to U.S. policies on often complicated treaty matters. For purposes of clarity and transparency in this area, the U.S. model tax treaties should reflect the most current positions on U.S. treaty policy. Periodically updating the U.S. model tax treaties to reflect changes, revisions, developments, and the viewpoints of Congress with regard to U.S. treaty policy would ensure that the model treaties remain meaningful and relevant.[33]

With assistance from the staff of the Joint Committee on Taxation, the Senate Committee on Foreign Relations reviews tax treaties negotiated and signed by the Treasury Department before ratification by the full Senate is considered. The U.S. model is important as part of this review process because it helps the Senate determine the Administration's most recent treaty policy and understand the reasons for diverging from the U.S. model in a particular tax treaty. To the extent that a particular tax treaty adheres to the U.S. model, transparency of the policies encompassed in the tax treaty is increased and the risk of technical flaws and unintended consequences resulting from the tax treaty is reduced.

Proposed treaty

It is recognized that tax treaties often diverge from the U.S. model due to, among other things, the unique characteristics of the legal and tax systems of treaty partners, the outcome of negotiations with treaty partners, and recent developments in U.S. treaty

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[32] Treasury Department, Technical Explanation of the United States Model Income Tax Convention, at 3 (September 20, 1996).

[33] The staff of the Joint Committee on Taxation has recommended that the Treasury Department update and publish U.S. model tax treaties once per Congress. Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS–3–01), April 2001, vol. II, pp. 445–447.

policy. However, even without taking into account the central features of tax treaties that predictably diverge from the U.S. model (e.g., withholding rates, limitation on benefits, exchange of information), the technical provisions of recent U.S. tax treaties have diverged substantively from the U.S. model with increasing frequency. The proposed treaty continues this apparent pattern,[34] which may be indicative of a growing obsolescence of the U.S. model.

Issue

While each instance of divergence from the U.S. model may be justified on an individual basis by particular factors relating to the development and negotiation of the proposed treaty, the cumulative effect of provisions of the proposed treaty that diverge from the U.S. model is that the tax policies incorporated into the proposed treaty are more obscured than they otherwise would have been if the proposed treaty had conformed more closely to the U.S. model. In addition, provisions of the proposed treaty that diverge from the U.S. model generally have not been as thoroughly considered and commented upon by various stakeholders as the U.S. model provisions. Consequently, such provisions of the proposed treaty carry a heightened risk of technical defects and opportunities for taxpayer abuse.

The Committee may wish to satisfy itself that the degree to which the proposed treaty diverges substantively from the U.S. model—in a continuation of the apparent pattern of recent U.S. tax treaties—does not unduly inhibit the review function of the Committee in the Senate treaty ratification process. In addition, the Committee may wish to satisfy itself that provisions of the proposed treaty that diverge from the U.S. model have not resulted in any technical deficiencies and opportunities for abuse that are substantial in relation to the overall objectives of the proposed treaty. The Committee also may wish to inquire of the Treasury Department as to the current state of the U.S. model and whether the Treasury Department has any intention of updating the U.S. model in the foreseeable future.

[34] Some of the provisions in the proposed treaty that diverge substantively from the U.S. model include: Article 2 (Taxes Covered), paragraph 2(b) (accumulated earnings tax and personal holding company tax); Article 6 (Income from Immovable Property) (taxpayer election to be taxed on a net basis); Article 7 (Business Profits), paragraph 4 (total profits apportionment to a permanent establishment); Article 9 (Associated Enterprises), paragraph 3 (saving clause); Article 16 (Income from Employment), paragraph 2 (remuneration from employment aboard ships or aircraft operated in international traffic); and Article 29 (Entry into Force), paragraph 2(b) (effective date for non-withholding taxes).