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EXPLANATION OF PROPOSED PROTOCOL TO THE INCOME TAX TREATY BETWEEN THE UNITED STATES AND AUSTRALIA

SCHEDULED FOR A HEARING

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, describes the proposed protocol to the existing income tax treaty between the United States of America and Australia (the "proposed protocol"). The proposed protocol was signed on September 27, 2001. The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed protocol for March 5, 2003.[2]

Part I of the pamphlet provides a summary of the proposed protocol. 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 an article-by-article explanation of the proposed protocol. Part IV contains a discussion of issues relating to the proposed protocol.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Australia* (JCS–5–03), March 3, 2003.

[2] For a copy of the proposed protocol, *see* Senate Treaty Doc. 107–20.

I. SUMMARY

The principal purposes of the existing treaty between the United States and Australia 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 existing 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.

The proposed protocol modifies several provisions in the existing treaty (signed in 1982) to make it similar to more recent U.S. income tax treaties, the 1996 U.S. model income tax treaty ("U.S. model"), and the 1992 model income tax treaty of the Organization for Economic Cooperation and Development, as updated ("OECD model"). However, the existing treaty, as amended by the proposed protocol, contains certain substantive deviations from these treaties and models.

The proposed protocol reduces source-country withholding tax rates under the existing treaty on dividends, interest, and royalties. First, the proposed protocol replaces Article 10 (Dividends) of the existing treaty with a new dividends article. This new article eliminates the withholding tax on certain intercompany dividends in cases in which an 80–percent ownership threshold is met. The new article preserves the maximum withholding tax rate of 15 percent on portfolio dividends, but provides a maximum withholding tax rate of 5 percent on dividends meeting a 10–percent ownership threshold. The proposed protocol replaces Article 11 (Interest) of the existing treaty with a new interest article that retains source-country taxation of interest at a maximum withholding tax rate of 10 percent, but allows a special zero rate of withholding for interest paid to financial institutions and governmental entities. The proposed protocol also retains source-country taxation of royalties under Article 12 (Royalties) of the existing treaty, but reduces the maximum level of withholding tax from 10 percent to 5 percent. In addition, the proposed protocol amends the definition of royalties to remove the portion of the definition related to payments for the use of "industrial, commercial or scientific equipment, other than equipment let under a hire purchase agreement." Thus, under the proposed protocol, leasing income is treated as business profits, taxable by the source country only if the recipient of the payments has a permanent establishment located in the source country.

The proposed protocol expands the "saving clause" provision in Article 1 (Personal Scope) of the existing treaty to allow the United States to tax former long-term residents whose termination of residency has as one of its principal purposes the avoidance of tax. This provision allows the United States to apply special tax rules under section 877 of the Code as amended in 1996.

The proposed protocol amends Article 2 (Taxes Covered) of the existing treaty to include certain U.S. and Australian taxes. For U.S. tax purposes, the accumulated earnings tax and the personal holding company tax are covered taxes under the proposed protocol. In the case of Australia, covered taxes include the Australian income tax, including tax on capital gains, and the resource rent tax (although the United States would not be required to allow a foreign tax credit with respect to the resource rent tax).

The proposed protocol provides that, for purposes of Article 4 (Residence) of the existing treaty, a U.S. citizen is treated as a resident of the United States unless the U.S. citizen is a resident of a country other than Australia for purposes of a tax treaty between that third country and Australia. In such case, the U.S. citizen is precluded from claiming benefits under the U.S.-Australia treaty and can only claim benefits under the tax treaty between such third country and Australia. The proposed protocol also adds a new provision under Article 7 (Business Profits) of the existing treaty to clarify the treatment of fiscally transparent entities and beneficial owners of fiscally transparent entities. The proposed protocol clarifies that permanent establishment status flows through a fiscally transparent entity (and thus the beneficial owner is treated as carrying on a business through such permanent establishment).

The proposed protocol amends the shipping provisions under Article 8 (Shipping and Air Transport) and related provisions under Article 13 (Alienation of Property) of the existing treaty to more closely reflect the treatment of income from the operation of ships, aircraft and containers in international traffic under the U.S. model.

The proposed protocol makes further amendments to Article 13 that allow income or gains from certain business property of a permanent establishment to be taxed in the country in which the permanent establishment is located. The proposed protocol also amends Article 13 to address Australia's imposition of its mark-to-market regime on individuals who expatriate to the United States.

The proposed protocol replaces Article 16 (Limitation on Benefits) of the existing treaty with a new article that reflects the limitation on benefits provisions included in more recent U.S. income tax treaties.

The proposed protocol also replaces Article 21 (Other Income) of the existing treaty with an article that more closely represents the provision included in the U.N. model tax treaty.

Article 13 of the proposed protocol provides for the entry into force of the modifications made by the proposed protocol.

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 1 or 4 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. EXPLANATION OF PROPOSED PROTOCOL

Article 1. Personal Scope

The proposed protocol expands the "saving clause" provision in Article 1 (Personal Scope) of the present treaty to include former long-term residents whose termination of residency had as one of its principal purposes the avoidance of tax.

Saving Clause

The personal scope article describes the persons who may claim the benefits of the present treaty. The present treaty generally applies to residents of the United States and Australia, with specific modifications to such scope in other articles. Like all U.S. income tax treaties and the U.S. model, the present treaty includes a "saving clause." Under this clause, with specific exceptions, the treaty does not affect the taxation by either treaty country of its residents or its citizens. Thus, the United States may continue to tax its citizens who are residents of Australia as if the treaty were not in force.

The present treaty contains a provision under which the saving clause (and therefore the U.S. jurisdiction to tax) applies for U.S. tax purposes to a former U.S. citizen whose loss of citizenship status had as one of its principal purposes the avoidance of U.S. tax; such application is limited to the ten-year period following the loss of citizenship status.

The proposed protocol expands the saving clause provision in the present treaty to include former long-term residents whose termination of residency had as one of its principal purposes the avoidance of tax. The expansion of this provision makes the treaty consistent with amendments to the U.S. tax rules under Code section 877 in 1996 related to former citizens and former long-term residents who relinquish citizenship or terminate residency.

Prior to the enactment of the Health Insurance Portability and Accountability Act of 1996, section 877 of the Code provided special rules for the imposition of U.S. income tax on former U.S. citizens for a period of ten years following the loss of citizenship; these special tax rules applied to a former citizen only if his or her loss of U.S. citizenship had as one of its principal purposes the avoidance of U.S. income, estate or gift taxes. The Health Insurance Portability and Accountability Act of 1996 expanded section 877 to apply also to certain former long-term residents of the United States. For purposes of applying the special tax rules to former citizens and long-term 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.

The proposed protocol reflects the reach of the U.S. tax jurisdiction pursuant to section 877 after its expansion by the Health In-

surance Portability and Accountability Act of 1996. Accordingly, the saving clause in the proposed protocol permits the United States to impose the special tax rules on former U.S. long-term residents who terminate residency with a principal purpose of avoiding U.S. income, estate, or gift taxes.

The term "long-term resident" is defined under U.S. domestic laws. The United States defines "long-term resident" as an individual (other than a U.S. citizen) who is a lawful permanent resident of the United States in at least 8 of the prior 15 taxable years. 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 under the provisions of a tax treaty between the United States and the foreign 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 certain benefits conferred by the articles dealing with Associated Enterprises (Article 9); Pensions, Annuities, Alimony and Child Support (Article 18); Relief from Double Taxation (Article 22); Nondiscrimination (Article 23); Mutual Agreement Procedure (Article 24); and certain sourcing rules (Article 27).

In addition, the saving clause does not apply to the benefits conferred by one of the countries under the articles dealing with Governmental Remuneration (Article 19), Students (Article 20), or Diplomatic and Consular Privileges (Article 26), upon individuals (1) who are not citizens of that conferring country and (2) who in the case of the United States do not have immigrant status, or who in the case of Australia are not ordinarily resident in Australia.

Article 2. Taxes Covered

The proposed protocol amends Article 2 (Taxes Covered) of the present treaty to include certain U.S. and Australian taxes. The present treaty provision generally applies to the income taxes of the United States and Australia.

United States

In the case of the United States, the present treaty applies to the Federal income taxes imposed by the Code, but excludes the accumulated earnings tax and the personal holding company tax. This treatment is different from the U.S. model, which specifies that both the accumulated earnings tax and the personal holding company tax are covered taxes.

The proposed protocol amends the present treaty to provide that all U.S. income taxes are covered taxes for purposes of the treaty. Thus, the accumulated earnings tax and the personal holding company tax are covered taxes under the proposed protocol. Under the Code, these taxes will not apply to most foreign corporations because of either a statutory exclusion or the corporation's failure to meet a statutory requirement. The proposed protocol continues to exclude social security taxes and excise taxes as under the present treaty. The U.S. model excludes social security taxes, but covers the excise tax on private foundations and (in certain cases) the excise tax on insurance premiums paid to foreign insurers.

Australia

In the case of Australia, the present treaty applies to the Australian income tax, including the additional tax upon the undistributed amount of the distributable income of a private company.

The proposed protocol provides that the covered taxes are (i) the Australian income tax, including tax on capital gains, and (ii) the resource rent tax in respect of offshore projects relating to exploration for or exploitation of petroleum resources ("RRT"), imposed under the federal law of Australia. The clarification with respect to the capital gains tax means that U.S. taxpayers will be able to receive a U.S. foreign tax credit for the capital gains tax paid. The proposed protocol's modification to the covered Australian taxes will expand the application of certain treaty provisions to include the RRT (i.e., Article 5 (Permanent Establishment), Article 7 (Business Profits) and Article 27 (Miscellaneous)). However, other modifications under the proposed protocol to Article 22 (Relief from Double Taxation) provide that the United States is not required to grant a foreign tax credit for RRT paid to Australia, even though the RRT is considered a covered tax under the treaty. This does not preclude U.S. companies from claiming a foreign tax credit for the RRT, but requires that a determination of the RRT's creditability be made under U.S. tax law.

The proposed protocol does not modify the provision contained in the present treaty (and generally found in U.S. income tax treaties) to the effect that it will apply to substantially similar taxes that either country may subsequently impose.

Article 3. Residence

The proposed protocol provides that, for purposes of Article 4 (Residence) of the present treaty, a U.S. citizen is treated as a resident of the United States unless the U.S. citizen is a resident of a country other than Australia for purposes of an income tax treaty between that third country and Australia. If the U.S. citizen qualifies as a resident under an income tax treaty between such third country and Australia, the proposed protocol precludes the U.S. citizen from claiming benefits under the U.S.-Australian treaty.

The assignment of a country of residence is important because the benefits of the present treaty generally are available only to a resident of one of the countries as that term is defined in the 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.

The present treaty defines a resident of the United States to include any United States corporation (as defined in Article 3 so as to exclude corporations with dual residence) and, subject to certain exceptions, any other person resident in the United States as determined under U.S. tax laws.

The proposed protocol provides rules related to the treatment of a U.S. citizen who is resident outside the United States. The proposed protocol modifies the present treaty to provide that a U.S. citizen is treated as a resident of the United States unless the U.S.

citizen is “a resident of a State other than Australia” for purposes of an income tax treaty between that third country and Australia.

This rule prevents a U.S. citizen who is a resident of a country other than the United States or Australia from choosing the benefits of the U.S.-Australia treaty over those provided by the tax treaty between Australia and his or her country of residence. The Technical Explanation gives the example of a U.S. citizen who is a resident of the United Kingdom and entitled to benefits under the U.K.-Australia tax treaty. Such individual is precluded from claiming benefits under the U.S.-Australia treaty and could claim only the benefits of the U.K.-Australia treaty.

If a U.S. citizen’s country of residence does not have a tax treaty with Australia (or if the U.S. citizen does not qualify as a “resident” of the third State for purposes of the tax treaty between that State and Australia), then he or she is treated as a resident of the United States and is allowed to take advantage of benefits under the U.S.-Australia treaty. If such individual is a resident of both the United States and Australia, the appropriate country of residence is determined by the “tie-breaker” rules provided under the present U.S.-Australia treaty.

The Technical Explanation states that such provision, in clarifying the treatment of a U.S. citizen, does not alter the application of the “saving clause” (i.e., the U.S. jurisdiction to tax). Thus, the fact that a U.S. citizen is not considered a U.S. resident under the U.S.-Australia treaty does not prevent the United States from continuing to tax such individual as if the U.S.-Australia treaty never went in to force. The Technical Explanation states that a U.S. citizen who, under this rule, is not considered to be a resident of the United States still is taxable on his worldwide income under generally applicable U.S. tax laws.

Article 4. Business Profits

The proposed protocol adds a new paragraph to Article 7 (Business Profits) of the present treaty to clarify that the permanent establishment status of a fiscally transparent entity flows through the entity, resulting in a permanent establishment for the beneficial owners of such entity.

Under the present treaty, the business profits of an enterprise of one of the countries are taxable in the other country if the enterprise carries on business through a permanent establishment within the other country, but only so much of the business profits that are attributable to that permanent establishment.

The taxation of business profits under the present treaty differs from United States rules for taxing business profits primarily by requiring more than merely being engaged in trade or business before a country can tax business profits and by substituting the “attributable to” standard for the Code’s “effectively connected” standard. Under the Code, all that is necessary for effectively connected business profits to be taxed is that a trade or business be carried on in the United States. Under the present treaty, on the other hand, some level of fixed place of business must be present and the business profits must be attributable to that fixed place of business.

The proposed protocol does not change the basic rule for taxing business profits under the present treaty. The proposed protocol clarifies the treatment of fiscally transparent entities (e.g. certain trusts) and beneficial owners of fiscally transparent entities. The clarification provision was requested by Australia because, under Australian law, the trustees of a trust (instead of the beneficiaries of a trust) are treated as carrying on any trade or business conducted by the trust. Thus, any trade or business that results in a permanent establishment is attributed to the trustees rather than the beneficiaries of the trust. The proposed protocol would clarify that permanent establishment status flows through a fiscally transparent entity.

The proposed protocol provides that if a fiscally transparent entity (or trustee) creates a permanent establishment in one of the two countries and a resident of the other country is beneficially entitled to a share of the business profits generated by the fiscally transparent entity (or trustee) through that permanent establishment, then the beneficial owner is treated as carrying on a business through a permanent establishment in that country, and its share of the business profits are attributed to the permanent establishment.

The Technical Explanation gives the example of a trust with a U.S. beneficiary carrying on a business in Australia through its trustee such that if that trustee's actions rise to the level of a permanent establishment, then the U.S. beneficiary will be treated as having a permanent establishment in Australia and the profits of the trust associated with that permanent establishment are considered business profits.

The Technical Explanation clarifies that because such provision was added solely to address Australian law relating to trusts, the absence of similar language in other U.S. tax treaties does not imply that a resident may avoid permanent establishment treatment and business profits by investing through a fiscally transparent entity.

Unlike some U.S. treaties and the U.S. model, the present treaty does not define the term "business profits." Thus, to the extent not dealt with in other Articles, the term is defined under the domestic laws of each country. If the definitions cause double taxation, the competent authorities agree on a common meaning of the term.

The present treaty contains a provision, not generally found in other treaties, that permits a country to determine the tax liability of a person under internal law where the information available to the competent authority of that country is inadequate to determine the profits attributable to a permanent establishment. However, on the basis of available information, the determination of the profits of the permanent establishment must be consistent with the principles of the Article.

Article 5. Shipping and Air Transport

The proposed protocol amends Article 8 (Shipping and Air Transport) to generally favor residence country taxation of income from the operation of ships, aircraft and containers in international traffic. The proposed protocol modifies the rules on the treatment of profits from the rental of ships and aircraft in international traffic,

the treatment of containers, and the use of profit-sharing arrangements. The proposed protocol also clarifies the treatment of inland transport of property and passengers.[3]

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.

Like the present treaty, the proposed protocol provides that profits that are derived by an enterprise of one country from the operation in international traffic of ships or aircraft are taxable only in that country.[4] Also, like the present treaty, the proposed protocol provides that profits from the operation of ships or aircraft in international traffic include profits derived from the rental of ships or aircraft on a full basis (i.e., with crew) if the lessor either operates ships or aircraft in international traffic or regularly leases ships or aircraft on a full basis.

The proposed protocol and the present treaty differ with respect to treatment of profits from the rental of ships or aircraft on a bareboat basis (i.e., without crew). Under the present treaty, if such rental activities are incidental to the activities from the operation of ships or aircraft in international traffic *and* the leased ships or aircraft are operated in international traffic, then the profits are treated as profits from the operation in international traffic of ships and aircraft and thereby subject to tax only in the resident country. The proposed protocol eliminates the requirement that the leased ships or aircraft actually be operated in international traffic in order to be eligible for resident country only taxation. The Technical Explanation notes that this provision is generally consistent with the OECD model but still is narrower than the U.S. Model, which also covers rentals from bareboat leasing that are not incidental to the operation of ships and aircraft in international traffic by the lessor.

Tracking the U.S. model, the proposed protocol 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 in international traffic is taxable only in that country. Unlike the present treaty, this is the result under the proposed protocol (and the U.S. model) regardless of whether: (1) the income recipient is a lessor; (2) the income is rental income that is incidental to income received from the operation of ships or aircraft in international traffic; and (3) the containers and related equipment are used in international traffic by a lessee. The Technical Explanation states that, by contrast to the U.S. model and the proposed protocol, the OECD model covers only income from the use, maintenance, or rental of containers that is incidental to other income

[3] The rules governing income from the disposition of ships, aircraft, and containers are in Article 13 (Alienation of Property) of the present treaty (as amended by Article 9 of the protocol).

[4] "International traffic" is defined in Article 3(1)(d) (General Definitions) as any transport by a ship or aircraft, except when the transport is solely between places in the other treaty country.

from international traffic. In addition, consistent with the U.S. model, the proposed protocol changes the reference from "containers and related equipment" in the present treaty to a reference to "containers (including trailers, barges, and related equipment for the transport of containers)."

Following the Australian model, the shipping and air transport provisions of the proposed protocol apply to profits derived from participation in a pool service or other profit sharing arrangement. This refers to various arrangements for international cooperation by carriers in shipping and air transport. By contrast, the present treaty refers only to profits derived from participation in a pool service, in a joint transport operating organization, or in an international operating agency. Similar to the present treaty, the U.S. model refers to profits derived from a pool, a joint business, or an international operating agency.

The proposed protocol clarifies the treatment of the inland transport of property and passengers. Under the present treaty, the definition of profits from the operation in international traffic of ships and aircraft does not include (and therefore the Article does not cover) profits derived from the carriage by ships or aircraft of passengers or certain property (livestock, mail, goods, or merchandise) that is shipped in one State for discharge at another place in that State. This rule has raised questions about the treatment of the domestic leg of an international trip. Accordingly, the proposed protocol provides that the carriage by ships or aircraft of passengers or certain property that is taken on board in one State for discharge in that State is not the operation in international traffic of ships or aircraft and may be taxed in that State. The Technical Explanation characterizes the protocol as consistent with the OECD model, namely that profits derived by an enterprise from the inland transport of property or passengers within either treaty country are treated as profits from the operation of ships or aircraft in international traffic (and, thus, governed by this Article) if such transport is undertaken as part of international traffic by the enterprise. For example, as described in the Technical Explanation, under the proposed protocol, if a U.S. enterprise contracts to carry property from Australia to the United States and, as part of the contract, it transports (or contracts to transport) the property by truck from its point of origin to an airport in Australia, the income earned by the U.S. enterprise from the overland leg of the journey would be taxable only in the United States. In addition, if a U.S. airline carries passengers from Los Angeles to Perth, with an intervening stop in Melbourne, the Melbourne-to-Perth leg of the trip would be treated as international transport of passengers with respect to passengers who boarded in Los Angeles (and taxable only in the United States) but not with respect to passengers who boarded in Melbourne. With respect to passengers who boarded in Melbourne, the profits related to such transport would not meet the definition of "international traffic." The Technical Explanation states that this Article also would apply to income from lighterage undertaken as part of the international transport of goods.

Article 6. Dividends

The proposed protocol replaces Article 10 (Dividends) of the present treaty with a new dividend article that generally provides for full residence country taxation and limited source country taxation of dividends. The proposed protocol would retain the maximum rate of withholding at source at 15 percent and would allow a 5 percent rate for dividends from 10–percent owned corporations. It would also permit a new zero rate of withholding tax on dividends from certain direct investments. Special rules are provided for dividends from regulated investment companies and real estate investment trusts.

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.

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.

Australia

Australia has an integrated tax system and by statute does not impose a withholding tax on dividend payments to nonresidents to the extent such dividends have born the full rate of Australian company tax (*i.e.,* "franked dividends"). When dividends are paid out of untaxed corporate profits (*i.e.,* "unfranked dividends"), withholding tax is imposed at a statutory rate of 30 percent, unless otherwise reduced by treaty. Australia does not currently impose a branch profits tax.

Proposed treaty limitations on internal law

Under the proposed protocol, 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, but the rate of such tax is limited. Under the proposed protocol, source-country taxation of dividends (i.e., taxation by the country in which the dividend-paying company is resident) generally is limited to 15 percent of the gross amount of the dividends paid to residents of the other treaty country. A lower rate of 5 percent applies if the beneficial owner of the dividend is a company that owns at least 10 percent of the voting stock of the dividend-paying company.

The term "beneficial owner" is not defined in the present treaty or proposed protocol 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.

In addition, the proposed protocol provides a zero rate of withholding tax with respect to certain intercompany dividends in cases in which there is a sufficiently high (80-percent) level of ownership (often referred to as "direct dividends").

80 percent intercompany ownership for 12 months

The proposed protocol reduces the withholding rate to zero on dividends beneficially owned by a company that has owned directly 80 percent or more of the voting power of the company paying the dividend for the 12–month period ending on the date the dividend is declared.

In general, in order to be eligible for this zero rate withholding, the beneficial owner company must be entitled to the benefits of the treaty under specified provisions of Article 16 (Limitation on Benefits), as modified by the proposed protocol, or have received a determination from the relevant competent authority.

Dividends paid by RICs and REITs

The proposed protocol generally denies the 5 percent and zero rates of withholding to dividends paid by a RIC or REIT.

The 15 percent rate of withholding is allowed for any dividends paid by a RIC. The 15 percent rate of withholding is allowed for dividends paid by a REIT only if one of three additional conditions is met. First, the dividend may qualify for the 15 percent rate if the person beneficially entitled to the dividend is an individual holding an interest of not more than 10 percent in the REIT. Second, the dividend may qualify for the 15 percent rate if it 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 5 percent of any class of the REIT's stock. Third, the dividend may qualify for the 15 percent rate if 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 these restrictions in availability of the different rates are intended to prevent the use of RICs and REITs to gain unjustifiable source-country benefits for certain shareholders resident in Australia. For example, a company resident in Australia could directly own a diversified portfolio of U.S. corporate shares and pay a U.S. withholding tax of 15 percent on dividends on those shares. There is a concern that such a company could purchase 10 percent or more of the interests in a RIC, which could even be established as a mere conduit, and, thus, obtain a lower withholding rate by holding a similar portfolio through the RIC (transforming portfolio dividends generally taxable at 15 percent into direct investment dividends taxable under the treaty at zero or 5 percent).

Similarly, the Technical Explanation gives an example of a resident of Australia directly holding real property and required to pay U.S. tax either at a 30 percent rate on gross income or at graduated rates on the net income. By placing the property in a REIT, the investor could transform real estate income into dividend in-

come, taxable at the rates provided in the proposed protocol. The limitations on REIT dividend benefits are intended to protect against this result.

Special rules apply to REIT dividends paid to listed Australian property trusts ("LAPTs"). A LAPT is a unit trust registered as an investment scheme, listed on a recognized Australian stock exchange, and regularly traded on one or more recognized exchanges. In order to encourage collective investment by small unitholders, LAPTs receive tax benefits under Australian law that are similar to those received by REITs in the United States. The tax benefits are intended to replicate the tax treatment of direct investment by such unitholders. Thus, the REIT provision included in recent U.S. tax treaties was modified to accommodate the Australian domestic laws by granting small unitholders generally the same benefits with respect to REIT shares that they would receive if they directly held such investments.

The special rules generally allow a 15 percent withholding rate for dividends paid by a REIT to a LAPT, notwithstanding the conditional requirements related to REIT dividends mentioned above. However, in the case of large unitholders, the 15 percent rate does not automatically apply to all the dividends paid by a REIT to a LAPT. If the responsible entity for the LAPT knows (or has reason to know) that one or more unitholders owns 5 percent or more of the beneficial interests in an LAPT, such unitholders will be subject to a look-through rule, whereby they are deemed to hold directly their proportionate interest in the REIT held through the LAPT, and they must satisfy one of the three conditional requirements to qualify for the 15 percent withholding rate on REIT dividends. Thus in satisfying one of the three conditional requirements, unitholders with an interest of five percent or more in a LAPT must take into account the REIT shares they own directly and the REIT shares they are deemed to own directly as a result of the look-through rule.

Following the example in the Technical Explanation, assume that a LAPT owns 40 percent of a REIT. One LAPT unitholder, individual A, owns 20 percent of the beneficial interests in the LAPT, and the responsible entity for the LAPT is aware of A's percentage of ownership interests. All other unitholders in the LAPT hold less than a 5 percent beneficial interest. Accordingly, A is treated as holding a portion of the LAPT's direct interest in the REIT equal to A's proportionate interest in the LAPT. Thus, A is treated as owning 8 percent of the REIT (.40 x .20) through A's LAPT investment. In addition to ownership interests in the LAPT, A owns directly 5 percent of the beneficial interests in the REIT. Thus, A's total beneficial interests in the REIT are 13 percent (8 percent through the LAPT and 5 percent held directly), preventing A from meeting one of the three conditional requirements related to REIT dividends and thereby denying A the benefit of the 15 percent withholding rate. The LAPT, however, is eligible for the 15 percent rate on the remaining 80 percent of the dividends (the portion not attributable to A's ownership interest) paid by the REIT to the LAPT.

Special rules and limitations

The proposed protocol's reduced rates of tax on dividends do not apply if the dividend recipient carries on business through a permanent establishment in the source country, or performs in the source country independent personal services from a fixed base located in that 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 or the fixed base are taxed as business profits (Article 7) or as income from the performance of independent personal services (Article 14), as the case may be.

The proposed protocol generally defines "dividends" as income from shares, as well as other amounts, which are subjected to the same taxation treatment as income from shares by the country in which the distributing corporation is resident. The Technical Explanation states that the term includes income from shares or other corporate rights, which carry the right to participate in profits, if such income is subject to the same tax treatment as income from shares by the country in which the distributing corporation is resident. The term also includes income from arrangements, including debt obligations, to the extent such income is so characterized under the laws of the country in which the income arises.

The proposed protocol prevents the United States from imposing a tax on dividends paid by an Australian company unless such dividends are paid to a resident of the United States or attributable to a permanent establishment or fixed base situated in the United States. Thus, this provision generally overrides the ability of the United States to impose a "second-level" withholding tax on the U.S.-source portion of dividends paid by an Australian corporation. The proposed protocol also restricts the United States from imposing corporate level taxes on undistributed profits, other than a branch profits tax.

The United States is allowed under the proposed protocol to impose the branch profits tax on an Australian corporation that either has a permanent establishment in the United States, or is subject to tax on a net basis in the United States on income from real property or gains from the disposition of 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 to its parent for the year if it had been operated as a separate U.S. subsidiary). In cases where an Australian corporation conducts a trade or business in the United States but not through a permanent establishment, the proposed protocol 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). Australia currently does not impose a branch profits tax. If Australia were to impose such tax, the base of such a tax would be limited to an amount analogous to the "dividend equivalent amount."

The imposition of the branch profits tax by the United States is precluded if an Australian company is considered a qualified person by reason of it being a publicly-traded company or a subsidiary of a publicly-traded company under Article 16 (Limitation on Bene-

fits), or if a such company is granted treaty benefits by the competent authorities under Article 16.

Article 7. Interest

The proposed protocol replaces Article 11 (Interest) with an article that retains source-country taxation of interest at a maximum rate of 10 percent, but allows a special zero rate of withholding for interest paid to financial institutions and governmental entities. The proposed protocol also contains certain provisions that more closely conform the present treaty to the U.S. model and to recent changes to U.S. domestic law.

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.

Australia

Australian-source interest payments to nonresidents generally are subject to withholding tax at a rate of 10 percent.

Proposed protocol limitations on internal law

The proposed protocol 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 similar to paragraphs (1) and (2) of Article 11 of the present treaty, but 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.

Like the present treaty, the proposed protocol limits the rate of source country tax that may be imposed on interest income. Under the proposed protocol, 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 the same as the present treaty rate, but is higher than the U.S. model rate, which is zero.

The proposed protocol provides a complete exemption from source country tax in the case of interest arising in a treaty country and (1) derived and beneficially owned by the Government of the other treaty country, including political subdivisions and local authorities thereof, or (2) derived and beneficially owned by a financial institution resident of the other treaty country which is unrelated to and dealing at arm's-length with the payer of the interest. For purposes of this provision, the proposed protocol defines the term "financial institution" to include a bank or other enterprise that derives substantially all of its profits by issuing indebtedness or by taking interest-bearing deposits and using proceeds from such indebtedness or deposits to carry on the business of providing finance.

The proposed protocol provides an anti-conduit provision under which the exemption from source country tax with respect to interest derived by a financial institution does not apply if such interest is paid as part of an arrangement involving back-to-back loans or an arrangement that is economically equivalent and intended to have a similar effect to back-to-back loans. The Technical Explanation states that the economic equivalent of back-to-back loans would include transactions that serve the economic purpose of back-to-back loans but do not meet the legal requirements of a loan. For example, the Technical Explanation states that the economic equivalent of back-to-back loans would include securities issued at a discount and certain swap arrangements that are intended to operate economically as back-to-back loans. The proposed protocol also provides that this anti-conduit provision does not restrict the right of a treaty country to apply any anti-avoidance provisions of its internal law. Accordingly, the Technical Explanation states that this provision does not limit the ability of the United States to enforce existing anti-avoidance provisions under U.S. domestic law, including in particular the rules of Treas. Reg. sec. 1.881–3, regulations adopted under the authority of section 7701(l) of the Code, and any other anti-avoidance provision of broad application (e.g., section 267). Similarly, the anti-conduit provision does

not limit the ability of a treaty country to enact or adopt new anti-avoidance provisions under its internal law.

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 includes premiums attaching to such securities, bonds, or debentures. 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 protocol 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 protocol 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 14 (Independent Personal Services).

The proposed protocol provides that interest is treated as arising in a treaty country if the payer is a resident of that country.[5] However, if the interest expense is borne by a permanent establishment or a fixed base, the interest will have as its source the country in which the permanent establishment or fixed base is located, regardless of the residence of the payer. Thus, for example, if a French resident has a permanent establishment in Australia and that French resident incurs indebtedness to a U.S. person, the interest on which is borne by the Australian permanent establishment, the interest would be treated as having its source in Australia. In the case of interest that is incurred by a U.S. branch of an Australian resident company, the Technical Explanation indicates that the interest expense allocation rules under U.S. law determine the amount of interest expense that is considered to be borne by the U.S. branch for purposes of this article.

The proposed protocol 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 present 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

[5] 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.

characterize a transaction to reflect its substance and impute interest under the authority of Article 9 (Associated Enterprises).

The proposed protocol provides two anti-abuse exceptions to the general source-country reductions in tax. The first exception relates to "contingent interest" payments. If interest is paid by a source-country resident and is determined with reference to the profits of the debtor or a related person, such interest may be taxed in the source country in accordance with its internal laws. However, if the beneficial owner is a resident of the other treaty country, such interest may not be taxed at a rate exceeding 15 percent (*i.e.,* the rate prescribed in paragraph 2(b) of Article 10 (Dividends)).

The second anti-abuse exception provides that the reductions in source country tax do not apply to interest paid with respect to ownership interests in a vehicle used for the securitization of real estate mortgages or other assets, to the extent that the amount of interest paid exceeds the normal rate of return on comparable publicly-traded debt instruments as specified by the domestic law of the source country. The Technical Explanation states that this provision ensures that the source country reductions in tax do not apply to excess income inclusions with respect to residual interests in a REMIC. This provision is analogous to the U.S. model, but is drafted reciprocally, presumably to apply to similar Australian securitization vehicles.

The proposed protocol provides that the reductions in source country tax apply to interest payments that are deemed to be received by a treaty country resident and allocated as interest expense for purposes of determining income that is attributable to a permanent establishment of such resident in the other treaty country or taxable on a net basis in the other treaty country as income from real property or gain on real property, to the extent such deemed interest payments exceed the actual interest paid by the permanent establishment or trade or business in the other treaty country. The Technical Explanation states that this provision extends the reduction in source country tax to include allocable excess interest that is determined under the branch-level interest tax provisions of U.S. internal law (sec. 884(f)).

Article 8. Royalties

The proposed protocol retains source-country taxation of royalties, but reduces the maximum level of withholding tax from 10 percent to 5 percent under Article 12 (Royalties) of the existing treaty. In addition, the proposed protocol amends the definition of "royalties" to treat certain leasing income as business profits and updates such definition to reflect technological advances since the present treaty was signed.

Internal taxation rules

United States

Under the same system that applies to dividends and interest, the United States imposes a 30–percent withholding tax on U.S.-source royalties paid to foreign persons. U.S.-source royalties include royalties for the use of or the right to use intangible property in the United States.

Australia

Australia generally imposes a withholding tax on royalties paid to nonresidents at a rate of 30 percent.

Proposed treaty limitations on internal law

The U.S. model exempts royalties beneficially owned by a resident of one country from source-based taxation in the other country. The present treaty differs from the U.S. model in that it allows the country where the royalties arise (the "source country") to tax such royalties. The proposed protocol maintains source country taxation of royalties, but reduces the present treaty withholding tax rate from 10 percent to 5 percent. The proposed protocol's 5 percent rate does not provide the full exemption found in many U.S. tax treaties and the U.S. model with respect to royalties, but Australia has not to date agreed to any treaty providing a rate lower than 5 percent.

The present treaty defines the term "royalties" to include any consideration for the use of, the right to use, or the sale (which is contingent on the productivity, use, or further disposition) of any copyright, patent, design or model, plan, secret formula or process, trademark or other like property or right; motion picture films; or films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting. The definition also includes consideration for the use of "industrial, commercial or scientific equipment, other than equipment let under a hire purchase agreement."

The proposed protocol amends the definition of "royalties" in two ways. First, it removes the portion of the definition related to payments for the use of "industrial, commercial or scientific equipment, other than equipment let under a hire purchase agreement." Thus, the leasing income related to such equipment is treated as business profits and taxable by the source country only if the recipient of the payments has a permanent establishment in the source country and such income is attributable to the permanent establishment. This treatment is consistent with the U.S. model, which treats such income as business profits and not as royalties. Second, the proposed protocol updates the definition of royalties to reflect technological advances since the present treaty was signed. The proposed protocol expands the provision to cover films, audio, video tapes, and disks, as well as any other means of image or sound reproduction or transmission, pursuant to television, radio, or other broadcasting. The Technical Explanation states that the provision would apply to a payment by an Australian broadcaster to a U.S. company for the right to transmit a live feed of an entertainment program over the airwaves or through cable, satellite, or the Internet. It would not however, apply to payments made by a retail customer who has subscribed to satellite television service provided by a U.S. company.

The proposed protocol's reductions in source country tax on royalties do not apply if (1) the beneficial owner of the royalties carries on business in the source country through a permanent establishment located in that country or performs in the source country independent personal services from a fixed base located in that country, and (2) the royalties are attributable to such permanent

establishment or fixed base. In such cases, the income is taxed as business profits (Article 7) or as independent personal services income (Article 14), as the case may be.

Article 9. Alienation of Property

The proposed protocol amends Article 13 (Alienation of Property) of the present treaty to modify the taxation of gains from the alienation of ships, aircraft, or containers operated or used in international traffic and from property pertaining to the operation or use in international traffic of ships, aircraft, or containers. The proposed protocol amends Article 13 of the present treaty to provide that income or gains from the alienation of certain business property of a permanent establishment or fixed base may be taxed in the country in which the permanent establishment or fixed base is located. The proposed protocol also amends Article 13 to provide for the taxation of gains of individuals who emigrate from one country to the other.

Ships, aircraft, and containers

Under the present treaty, gains with respect to ships, aircraft, or containers that are part of the business of a resident of one country are taxable in that country except to the extent that the business was allowed depreciation with respect to the ships, aircraft, or containers in the other country. The proposed protocol would provide that gains with respect to ships, aircraft, or containers are taxable only by the country in which the business owning the property is resident. Thus, the gains that might be realized with respect of international traffic in the United States would not be subject to income tax in United States if the owner of the property giving rise to the gain were a resident of Australia. Likewise, the gains that might be realized with respect of international traffic in the Australia would not be subject to income tax in Australia if the owner of the property giving rise to the gain were a resident of the United States.

Certain gains on business property

Article 13 of the present treaty generally makes provision for the taxation of income or gains of a resident of one country from the alienation or disposition of real property located in the other country. The proposed protocol would provide that certain gains from the alienation of property, other than real property, forming part of the business property of a permanent establishment or fixed base in one country of a business resident in the other country may be taxed only by the country in which the permanent establishment or fixed base is located. The Technical Explanation provides an example of a resident of Australia that is a partner in a partnership doing business in the United States. The Australian partner will have a permanent establishment in the United States as a result of the activities of the partnerships. Under the proposed protocol, the United States may tax the Australian partner's distributive share of income realized by the partnership on the disposition of personal property forming part of the business property of the partnership in the United States.

Emigrating Individuals

The proposed protocol provides for the taxation of gains of an individual who emigrates from one country to the other and, as a result, becomes subject to special tax rules in the country from which the individual emigrated. The Technical Explanation observes that under present law, this provision applies only to a resident of Australia who terminates his or her residency in Australia and becomes resident in the United States. Under Australian law, an individual who terminates Australian residence generally is treated as recognizing gain as though he or she disposed of all non-Australian assets. However, subject to certain conditions, an Australian resident may elect to defer the taxation of income or gain from this deemed sale.

The proposed protocol provides that where the individual who terminates residency pays tax on the deemed sale, the other country (the United States under present law) shall treat the property as sold and re-acquired before the individual became resident in the United States. The effect of this provision is to step up the individual's basis to the fair market value of the assets deemed to have been sold in the other country (Australia under present law). Thus, regardless of whether any U.S. tax was triggered by the deemed sale, the individual's basis for future computation of gain under the U.S. income tax will be the fair market value of the asset immediately before taking up residency in the United States. In the case where the individual who terminates residency in one country for residency in the other country, but elects to defer the tax from that first country's deemed disposition rule (Australia under present law), the proposed protocol provides that only the other country (the United States under present law) may tax the gain realized upon subsequent disposition of the assets.

Article 10. Limitation on Benefits

The proposed protocol replaces Article 16 (Limitation on Benefits) of the present treaty with an article that reflects the limitation on benefits provisions included in more recent U.S. income tax treaties. These provisions are intended to limit the benefits of the treaty to qualified residents of the United States and Australia.

The income tax treaty between the United States and Australia is intended to limit double taxation caused by the interaction of the two countries tax systems as they apply to residents of the two jurisdictions. At times, however, residents of third countries attempt to use the treaty. Such use is known as "treaty shopping" and refers to the situation where a person who is not a resident of either country seeks certain benefits under the income tax treaty between the two countries. Under certain circumstances, and without appropriate safeguards, the nonresident is able indirectly to secure these benefits by establishing a corporation (or other entity) in one of the countries which, 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 repatriate funds to that third country from the entity under favorable conditions (i.e., it may be possible to reduce or eliminate taxes on the repatriation) either through relaxed tax provisions in the distributing country or by passing the funds

through other treaty countries (essentially, continuing to treaty shop), until the funds can be repatriated under favorable terms.

Qualified Person

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

(1) An individual;

(2) One of the two countries or a governmental entity of one of the two countries;

(3) A company that satisfies a public company test and certain subsidiaries of such companies;

(4) An entity other than a company that satisfies a public ownership test and certain subsidiaries of such entities;

(5) A tax-exempt organization operated exclusively for religious, charitable, educational, scientific, or similar purposes;

(6) A tax-exempt pension scheme or employee benefit arrangement that meets an ownership test;

(7) An entity that satisfies an ownership test and a base erosion test; or

(8) A recognized headquarters for a multinational corporate group.

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 may be entitled to the benefits of the treaty if the source country's competent authority so determines.

Individuals

Under the proposed protocol, individual residents of the United States and Australia are entitled to all treaty benefits. However, if such an individual receives income as a nominee on behalf of a third country resident, and thus is not the beneficial owner of such income, benefits may be denied.

Governmental entities

The proposed protocol provides that the United States and Australia, any political subdivision or local authority of the two countries, or any agency or instrumentality of the two countries is entitled to all treaty benefits. The proposed protocol departs from the language used in most U.S. income tax treaties and the U.S. model with respect to governmental entities, but there is no material difference between the provisions with respect to limiting benefits.

Public company tests

A company that is a resident of the United States or Australia is entitled to treaty benefits if the principal class of its shares is listed on a recognized U.S. or Australian stock exchange and is regularly traded on one or more recognized stock exchanges. Thus,

such a company is entitled to the benefits of the treaty regardless of where its actual owners reside.

The term "recognized stock exchange" means the NASDAQ System owned by the National Association of Securities Dealers; any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934; the Australian Stock Exchange and any other stock exchange recognized under Australian law; and any other stock exchange agreed upon by the competent authorities of the two countries.

The term "principal class of shares" is not a defined term under Article 3 (General Definitions). Accordingly, such term is defined by reference to the domestic laws of each country from which treaty benefits are sought, generally the source country. Under U.S. tax law, the term is generally defined as the common shares of the company representing the majority of the aggregate voting power and value of the company. The Technical Explanation states that if the company does not have a class of ordinary or common shares representing the majority of the aggregate voting power and value of the company, then the "principal class of shares" is the class (or any combination of classes) of shares that represent, in the aggregate, a majority of the voting power and value of the company. The term "shares" includes depository receipts for shares or trust certificates for shares.

The term "regularly traded" is also not a defined term for purposes of the treaty. In accordance with Article 3 (General Definitions), such term is defined by reference to the domestic laws of each country from which the treaty benefits are sought, generally the source country. 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), relating to the branch tax provisions of the Code. Under these regulations, 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. (The Technical Explanation 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 treaty.) The Technical Explanation also provides that the regularly traded requirement can be met by trading on any recognized exchange or exchanges located in either country and that trading on one or more recognized stock exchanges may be aggregated for purposes of this requirement. Thus, a U.S. company could satisfy the regularly traded requirement through trading, in whole or in part, on a recognized stock exchanges located in Australia or on a stock exchange in a third country (if agreed upon by competent authorities). Authorized but unissued shares are not considered for purposes of this test.

In addition, a company that is a resident of the United States or Australia is entitled to treaty benefits if at least 50 percent of the aggregate vote and value of the company's shares is owned (directly or indirectly) by five or fewer companies that satisfy the test pre-

viously described, provided that each intermediate owner used to satisfy the control requirement is a resident of the United States or Australia. This rule allows certain subsidiaries of publicly traded companies to take advantage of all benefits under the treaty.

To further illustrate this rule, the Technical Explanation provides an example of an Australian company all of the shares of which are owned by an Australian parent company such that the Australian company would qualify for benefits under the treaty if the principal class of shares of the Australian parent company were listed on the Australian Stock Exchange and regularly traded on a recognized U.S. or Australian stock exchange. Under the same example, the Australian company would not qualify for benefits under this provision if the publicly traded parent company were resident in Canada, instead of the United States or Australia. Furthermore, if the Australian parent indirectly owned the Australian company through a chain of subsidiaries, each such subsidiary in the chain, as an intermediate owner, must be a resident of the United States or Australia for the Australian company to meet the requirements of such provision.

Public entity tests

Under the proposed protocol, a person other than an individual or company that is a resident of the United States or Australia is entitled to treaty benefits if the principal class of units in that entity is listed or admitted to dealings on a recognized U.S. or Australian stock exchange and is regularly traded on one or more recognized stock exchanges. Alternatively, the entity is entitled to treaty benefits if the direct or indirect owners of at least 50 percent of the beneficial interests in the entity are public entities under the preceding sentence or public companies described below.

The Technical Explanation provides that this provision generally applies to trusts if their shares of ownership are publicly traded and to trusts that are owned by publicly traded entities. The United States generally would consider such entities to be companies covered by the public company tests described above, making this provision redundant for U.S. tax purposes.

The Technical Explanation provides an example of an Australian trust, where the majority of shares of ownership are owned by a second Australian trust such that if the principal class of units of the second Australian trust are listed and regularly traded on the Australian Stock Exchange, the first Australian trust would meet the requirement of a qualified person under such provision. However, if the second Australia trust was a resident of Japan, and not the United States or Australia, the first Australian trust would not qualify for benefits under the provision.

Tax-exempt and charitable organizations

Under the proposed protocol, an entity is entitled to treaty benefits if it is organized under U.S. or Australian law and established and maintained exclusively for religious, charitable, educational, scientific or similar purposes (notwithstanding that all or part of its income is tax-exempt). There is no requirement that specified percentages of the beneficiaries of these organizations be residents of the United States or Australia.

Pension Funds

Under the proposed protocol, certain pension funds are entitled to benefits under the treaty. An entity qualifying under this provision is one that is organized under U.S. or Australian law and established and maintained in the country of residence to provide, pursuant to a plan, pensions or other similar benefits to employed and self-employed persons (notwithstanding that all or part of its income is tax-exempt). For the entity to be a qualified person, however, more than 50 percent of the entity's beneficiaries, members, or participants, must be individuals resident in either the United States or Australia. The term "beneficiaries" refers to individuals receiving benefits from the organization.

Ownership and base erosion tests

Under the proposed protocol, an entity that is a resident of the United States or Australia 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 period, shares or other beneficial interests representing at least 50 percent of the entity's aggregate voting power and value is owned (directly or indirectly) by certain qualified persons described above (i.e., individuals, governmental entities, companies that meet the public company test, and entities that meet the public entity test).

The Technical Explanation 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. Under the ownership test, the beneficial interests in a trust are considered to be owned by its beneficiaries in proportion to each beneficiary's actuarial interest in the trust. The interest of a remainder beneficiary will be equal to 100 percent less the aggregate percentages held by income beneficiaries. A beneficiary's interest in a trust is not considered to be owned by a person entitled to benefits under other "qualified person" categories under this provision if it is not possible to determine the beneficiary's actuarial interest. Consequently, if it is not possible to determine the actuarial interest of any beneficiaries in a trust, the ownership test cannot be satisfied, unless all beneficiaries are persons entitled to benefits under other "qualified person" categories.

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. The term "gross income" is not defined in the treaty. Thus, in accordance with Article 3, such term is to ascribe the meaning it has under U.S. tax law. The Technical Explanation states that in the case of the United States, the term "gross income" has the same meaning as under section 61 of the Code and the regulations thereunder. To the extent they are deductible from the taxable base, trust distributions are deductible payments. In addition, for purposes of this test, 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 a bank; provided that, if the bank is not a resident of one of the countries such pay-

ment is attributable to a permanent establishment of that bank located in one of the countries.

Headquarters company

Under the proposed protocol, a resident of the United States or Australia is entitled to treaty benefits if that person functions as a headquarters company for a multinational corporate group. A person is considered a headquarters company for this purpose only if each of several criteria is satisfied.

Overall supervision and administration

The person seeking such treatment must provide a substantial portion of the overall supervision and administration of the group. The Technical Explanation provides that a person will be considered to engage in supervision and administration if it engages in a number of the following activities: group financing, pricing, marketing, internal auditing, internal communications, and management. However, such company cannot be principally involved group financing. The above-mentioned functions are not an exhaustive list, but intended to be suggestive of the types of activities in which a headquarters company will be expected to engage. Furthermore, it is understood that in determining if a substantial portion of the overall supervision and administration of the group is provided by the headquarters company, the activities it performs as a headquarters company for the group must be substantial in comparison to the same activities for the same group performed by other entities within the multinational group.

For example, a Japanese corporation establishes a subsidiary in Australia to function as a headquarters company for its Asia-Pacific operations. The Japanese corporation also has two other subsidiaries functioning as headquarter companies—one for the African operations and one for the North American operations. The Australia headquarters company is the parent company for the subsidiaries through which the Asia-Pacific operations are carried on. The Australian headquarters company supervises the bulk of the pricing, marketing, internal auditing, internal communications and management for its group. Although the Japanese overall parent sets the guidelines for all of its subsidiaries in defining the worldwide group policies with respect to each of these activities, and assures that these guidelines are carried out within each of the regional groups, it is the Australian headquarters company that monitors and controls the way in which these policies are carried out within the group of companies that it supervises. The capital and payroll devoted by the Japanese parent to these activities relating to the group of companies the Australian headquarter company supervises is small relative to the capital and payroll devoted to these activities by the Australian headquarters company. Moreover, neither the other two headquarter companies, nor any other related company besides the Japanese parent company, perform any of the above-mentioned headquarter activities with respect to the group of companies that the Australian headquarters company supervises. In the above case, the Australian headquarters company would be considered to provide a substantial portion of the overall supervision and administration of the group it supervises.

The proposed protocol does not require that the group that is supervised include persons in the other country. However, the Technical Explanation makes clear that it is anticipated that in most cases the group will include such persons, due to the requirement that the income derived by the headquarters company be derived in connection with or be incidental to an active trade or business supervised by the headquarters company (described below).

Active trade or business

Either for the taxable year concerned, or as an average for the preceding four years, the activities and gross income of the corporate group that the headquarters company supervises and administers must be spread sufficiently among different countries. To satisfy the active trade or business requirement, the group must consist of corporations resident in, and engaged in an active business in, at least five countries, and the income derived in the treaty country of which the headquarter company is not a resident must be derived in connection with, or be incidental to, that active business. The business activities carried on in each of the five countries (or five groupings of countries) must generate at least 10 percent of the gross income of the group.

Single country limitation

The business activities carried on in any one country other than the country where the headquarter company resides cannot generate 50 percent or more of the gross income of the group. As mentioned above, the proposed protocol states that if the gross income requirement under this clause is not met for a taxable year, the taxpayer may satisfy this requirement by averaging the ratios for the four years preceding the taxable year. The Technical Explanation provides an example of such application:

Example: AHQ is a corporation resident in Australia. AHQ functions as a headquarters company for a group of companies. AHQ derives dividend income from a U.S. subsidiary in the 2004 taxable year. The state of residence of each of these companies, the situs of their activities and the amounts of gross income attributable to each for the years 2004 through 2008 are set forth below:

Company	Situs	2008	2007	2006	2005	2004
United States	U.S.	$100	$100	$95	$90	$85
United States	Mexico	10	8	5	0	0
United States	Canada	20	18	16	15	12
United Kingdom	U.K.	30	32	30	28	27
New Zealand	N.Z.	40	42	38	36	35
Japan	Japan	35	32	30	30	28
Singapore	Singapore.	25	25	24	22	20
Total		260	257	238	221	207

Because the United States' total gross income of $130 in 2007 is not less than 50 percent of the gross income of the group, the provision is not satisfied with respect to dividends derived in 2007. How-

ever, the United States' average gross income for the preceding four years may be used in lieu of the preceding year's average. The United States' average gross income for the years 2004–2007 is $111.00 ($444/4). The group's total average gross income for these years is $230.75 ($923/4). Because $111.00 represents 48.1 percent of the group's average gross income for the years 2004 through 2007, the United States satisfies such provision.

Other country gross income limitation

No more than 25 percent of the headquarter company's gross income may be derived from the treaty country of which it is not a resident. Thus, if the headquarters company's gross income for the taxable year is $100, no more than $25 of this amount may be derived from the other country. As with the single country limitation calculation, the proposed protocol provides that if the gross income requirement under this clause is not met for the taxable year, the taxpayer may satisfy this requirement by averaging the ratios for the four years preceding the taxable year.

Independent Discretionary Authority

The headquarters company must have and exercise independent discretionary authority to carry out the overall supervision and administration functions mentioned in the overall supervision and administration requirement, above. The Technical Explanation states that this determination is made separately for each function. Thus, if a headquarters company is nominally responsible for group financing, pricing, marketing, and internal auditing functions, and another entity is actually directing the headquarters company as to the group financing function, the headquarters company would not be deemed to have independent discretionary authority for group financing, but it may have such authority for the other functions.

Income taxation rules

The headquarters company must be subject to the generally applicable income taxation rules in its country of residence. The Technical Explanation states that this reference should be understood to mean that the company must be subject to the income taxation rules to which a company engaged in the active trade or business would be subject. Thus, if one of the countries introduced special taxation legislation that would impose a lower rate of income tax on headquarter companies than was imposed on companies engaged in the active conduct of a trade or business, or would provide for an artificially low taxable base for such companies, a headquarters company subject to these rules would not be entitled to the benefits under such provision.

In connection with or incidental to a trade or business

The income derived in the other country must be derived in connection with or be incidental to the active business activities referred to in the active trade or business requirement, above. For example, if an Australian company that satisfied the other requirements of this sub-section acted as a headquarters company for a group that included a United States corporation, and the group was engaged in the design and manufacture of computer software, but

the U.S. company was also engaged in the design and manufacture of photocopying machines, the income that the Australian company derived from the United States would have to be derived in connection with or be incidental to the income generated by the computer business in order to be entitled to treaty benefits under this subsection. Similarly, interest income received from the U.S. company also would be entitled to the benefits of the treaty under this paragraph as long as the interest was attributable to a trade or business supervised by the headquarters company. Interest income derived form an unrelated party would normally not, however, satisfy the requirements of this clause.

Active business test

Under the active business test, residents of one of the countries are entitled to treaty benefits with respect to income, profit, or gain 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 protocol 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 term "trade or business" is not defined in the treaty. However, as provided in Article 3 (General Definitions), undefined terms are to have the meaning which they have under the domestic laws of each country. 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." In general, a trade or business will be considered to be a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit.

The Technical Explanation provides that for purposes of this test, income is derived "in connection" with a trade or business if the income-producing activity in the source country is a line of business that forms a part of or is complementary to the trade or business conducted in the country of residence by the income recipient. A business activity generally will be considered to "form a part of" a business activity conducted in the other country if the two activities involve the design, manufacture or sale of the same products or type of products, or the provision of similar services. In order for two activities to be considered to be "complementary," the activities need not relate to the same types of products or services, but they should be part of the same overall industry and be related in the sense that the success or failure of one activity will tend to result in success or failure of the other. The Technical Explanation provides several different examples of the application of this rule.

The Technical Explanation also provides that income derived from a country will be "incidental" to a trade or business conducted in the other country if the production of such income facilitates the conduct of trade or business in the other country. An example of

incidental income is the temporary investment of working capital derived from a trade or business.

The proposed protocol 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 such determination 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. This treatment differs from some recent U.S. tax treaties (*i.e.,* Luxembourg, Netherlands) that include percentage thresholds that provide a safe harbor for determining the substantiality of a trade or business.

The proposed protocol provides that in determining whether a person is engaged in the active conduct of a trade or business, activities conducted by a partnership in which that person is a partner and activities conducted by persons connected to such person will be deemed to be conducted by such person. For this purpose, a person is connected to another person if (1) one person owns at least 50 percent of the beneficial interest in the other person (or, in the case of a company, owns shares representing at least 50 percent of the aggregate voting power and value of the company or the beneficial interest in the company), or (2) another person owns, directly or indirectly, at least 50 percent of the beneficial interest in each person (or, in the case of a company, owns shares representing at least 50 percent of the aggregate voting power and value of the company or the beneficial interest in the company). The proposed protocol provides that in any case, persons are considered to be connected if on the basis of all the facts and circumstances, one has control of the other or both are under the control of the same person or persons.

Disproportionate interests

The proposed protocol denies benefits to the disproportionate part of income earned by certain companies. Under the proposed protocol, a company that is a resident of one of the countries or a company that controls such a company has outstanding a class of shares: (1) that is subject to terms or other arrangements that entitle its holders to a portion of the income, profit, or gain of the company derived from the other country that is larger than the portion such holders would receive in the absence of such terms and arrangements, and (2) in which 50 percent or more of the voting power and value is owned by persons who are not equivalent beneficiaries (as defined above), then the benefits of the proposed treaty will apply only to that proportion of the income which those holders would have received in the absence of those terms or arrangements.

Grant of treaty benefits by the competent authority

The proposed protocol 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. Under this provision, such a person may be granted treaty benefits

if the competent authority of the source country determines that the establishment, acquisition, or maintenance of such resident and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the treaty.

The Technical Explanation provides that if the competent authority determines that benefits are to be allowed, they will be allowed retroactively to the time of entry into force of the relevant treaty provision or the establishment of the structure in question, whichever is later.

The proposed protocol provides that the competent authority of the source country must consult with the competent authority of the residence country before refusing to grant benefits under this provision.

Article 11. Other Income

The proposed protocol replaces Article 21 (Other Income) with an article that more closely represents the provision included in the U.N. model tax treaty.

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 Australia.

Under the proposed protocol, this rule gives the United States the sole right to tax income derived from sources in a third country and paid to a U.S. resident. This article is subject to the saving clause, so U.S. citizens who are residents of Australia will continue to be taxable by the United States on their third-country income.

The general rule just stated does not apply to income (other than income from real property as defined in Article 6 (Income from Real Property) if the beneficial owner of the income is a resident of one country and carries on business in the other country through a permanent establishment, or performs services in the other country from a fixed base, and the right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such a case, the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, will apply. Such exception also applies where the income is received after the permanent establishment or fixed base is no longer in existence, but the income is attributable to the former permanent establishment or fixed base.

The proposed protocol provides that notwithstanding the foregoing rules, items of income of a resident of a country not dealt with in the other articles of the proposed treaty and arising in the other country, may also be taxed by that other country. This rule, which is not contained in the U.S. and OECD models, is similar to the corresponding rule in the U.N. model.

Article 12. Relief from Double Taxation

The proposed protocol makes a conforming change to Article 22 (Relief from Double Taxation) of the present treaty to reflect changes made by the protocol to Article 2 (Taxes Covered) of the present treaty. Under the proposed protocol, the United States is not required to allow a foreign tax credit with respect to the re-

source rent tax ("RRT"). The determination of whether the RRT is a creditable tax will be made under U.S. tax law.

Article 13. Entry into Force

Article 13 of the proposed protocol relates to the entry into force of the modifications provided in the protocol.

The article provides that the proposed protocol 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 protocol will enter into force upon the exchange of instruments of ratification.

With respect to the United States, the proposed protocol will be effective with respect to withholding taxes on dividends, royalties and interest for amounts derived by a non-resident on or after the later of the first day of the second month next following the date on which the proposed protocol enters into force or July 1, 2003. With respect to other taxes, the proposed protocol will be effective for taxable periods beginning on or after the first day of January next following the date on which the proposed protocol enters into force.

With respect to Australia, the proposed protocol will be effective with respect to withholding taxes on dividends, royalties and interest for amounts derived by a non-resident on or after the later of the first day of the second month next following the date on which the proposed protocol enters into force or July 1, 2003. With respect to other Australian tax, in relation to income, profits or gains, the proposed protocol will be effective for any year of income beginning on or after July 1 next following the date on which the proposed protocol enters into force.

The article provides a special rule for certain REIT dividends received by a LAPT. This rule is intended to protect existing investments in REITs by LAPTs. For REIT shares owned by an LAPT on March 26, 2001 or acquired by the LAPT pursuant to a binding contract entered into on or before March 26, 2001 ("grandfathered REIT shares"), dividends from the grandfathered REIT shares are subject to the provisions of Article 10 (Dividends) as in effect on March 26, 2001. Thus, the dividends from the grandfathered REIT shares will be subject to a maximum withholding tax rate of 15 percent, regardless of the ownership of the LAPT. REIT shares acquired by the LAPT pursuant to a reinvestment of dividends (ordinary or capital) from grandfathered REIT shares are also treated as grandfathered REIT shares.

IV. ISSUES

A. Zero Rate of Withholding Tax on Dividends from 80–Percent-Owned Subsidiaries

In general

The proposed protocol would eliminate withholding tax on dividends paid by one corporation to another corporation that owns at least 80 percent of the stock of the dividend-paying corporation (often referred to as "direct dividends"), provided that certain conditions are met (subparagraph 3(a) of Article 10 (Dividends)). The elimination of withholding tax under these circumstances is intended to reduce further the tax barriers to direct investment between the two countries.

Currently, no U.S. treaty provides for a complete exemption from withholding tax under these circumstances, nor do the U.S. or OECD models. However, many bilateral tax treaties to which the United States is not a party eliminate withholding taxes under similar circumstances, and the same result has been achieved within the European Union under its "Parent-Subsidiary Directive." In addition, the United States has signed a proposed treaty with the United Kingdom and a proposed protocol with Mexico that include zero-rate provisions similar to the one in the proposed protocol.

Description of provision

Under the proposed protocol, the withholding tax rate is reduced to zero on dividends beneficially owned by a company that has owned at least 80 percent of the voting power of the company paying the dividend for the 12–month period ending on the date the dividend is declared (subparagraph 3(a) of Article 10 (Dividends)). Under the current U.S.-Australia treaty, these dividends may be taxed at a 5–percent rate.

Issues

In general

Given that the United States has never before agreed bilaterally to a zero rate of withholding tax on direct dividends, the Committee may wish to devote particular attention to the benefits and costs of taking this step. The Committee also may want to determine whether the inclusion of the zero-rate provision in the proposed protocol (as well as in the proposed treaty with the United Kingdom and the proposed protocol with Mexico) signals a broader shift in U.S. treaty policy, and under what circumstances the United States may seek to include similar provisions in other treaties. Finally, the Committee may wish to note the ramifications of including this provision in the U.S.-Australia treaty in view of a

"most favored nation" provision relating to this subject in the current U.S.-Mexico treaty.

Benefits and costs of adopting a zero rate with Australia

Tax treaties mitigate double taxation by resolving the potentially conflicting claims of a residence country and a source country to tax the same item of income. In the case of dividends, standard international practice is for the source country to yield mostly or entirely to the residence country. Thus, the residence country preserves its right to tax the dividend income of its residents, and the source country agrees either to limit its withholding tax to a relatively low rate (e.g., 5 percent) or to forgo it entirely.

Treaties that permit a positive rate of dividend withholding tax allow some degree of double taxation to persist. To the extent that the residence country allows a foreign tax credit for the withholding tax, this remaining double taxation may be mitigated or eliminated, but then the priority of the residence country's claim to tax the dividend income of its residents is not fully respected. Moreover, if a residence country imposes limitations on its foreign tax credit,[6] withholding taxes may not be fully creditable as a practical matter, thus leaving some double taxation in place. For these reasons, dividend withholding taxes are commonly viewed as barriers to cross-border investment. The principal argument in favor of eliminating withholding taxes on certain direct dividends in the proposed treaty is that it would remove one such barrier.

Direct dividends arguably present a particularly appropriate case in which to remove the barrier of a withholding tax, in view of the close economic relationship between the payor and the payee. Whether in the United States or in Australia, the dividend-paying corporation generally faces full net-basis income taxation in the source country, and the dividend-receiving corporation generally is taxed in the residence country on the receipt of the dividend (subject to allowable foreign tax credits). If the dividend-paying corporation is at least 80–percent owned by the dividend-receiving corporation, it is arguably appropriate to regard the dividend-receiving corporation as a direct investor (and taxpayer) in the source country in this respect, rather than regarding the dividend-receiving corporation as having a more remote investor-type interest warranting the imposition of a second-level source-country tax.

Since both the United States and Australia currently impose withholding tax on some or all direct dividends as a matter of domestic law (albeit only on "unfranked" dividends in the case of Australia), the provision would provide immediate and direct benefits to the United States as both an importer and an exporter of capital. The overall revenue impact of this provision is unclear, as the direct revenue loss to the United States as a source country would be offset in whole or in part by a revenue gain as a residence country from reduced foreign tax credit claims with respect to Australian withholding taxes.

Although the United States has never agreed bilaterally to a zero rate of withholding tax on direct dividends, many other countries have done so in one or more of their bilateral tax treaties. These

[6] *See, e.g.,* Code sec. 904.

countries include OECD members Austria, Denmark, France, Finland, Germany, Iceland, Ireland, Japan, Luxembourg, Mexico, the Netherlands, Norway, Sweden, Switzerland, and the United Kingdom, as well as non-OECD-members Belarus, Brazil, Cyprus, Egypt, Estonia, Israel, Latvia, Lithuania, Mauritius, Namibia, Pakistan, Singapore, South Africa, Ukraine, and the United Arab Emirates. In addition, a zero rate on direct dividends has been achieved within the European Union under its "Parent-Subsidiary Directive." Finally, many countries have eliminated withholding taxes on dividends as a matter of internal law (e.g., the United Kingdom and Mexico). Thus, although the zero-rate provision in the proposed treaty is unprecedented in U.S. treaty history, there is substantial precedent for it in the experience of other countries. It may be argued that this experience constitutes an international trend toward eliminating withholding taxes on direct dividends, and that the United States would benefit by joining many of its treaty partners in this trend and further reducing the tax barriers to cross-border direct investment.

General direction of U.S. tax treaty policy

Looking beyond the U.S.-Australia treaty relationship, the Committee may wish to determine whether the inclusion of the zero-rate provision in the proposed protocol (as well as in the proposed treaty with the United Kingdom and the proposed protocol with Mexico) signals a broader shift in U.S. tax treaty policy. Specifically, the Committee may want to know whether the Treasury Department: (1) intends to pursue similar provisions in other proposed treaties in the future; (2) proposes any particular criteria for determining the circumstances under which a zero-rate provision may be appropriate or inappropriate; (3) expects to seek terms and conditions similar to those of the proposed treaty in connection with any zero-rate provisions that it may negotiate in the future; and (4) intends to amend the U.S. Model to reflect these developments.[7]

"Most favored nation" agreement with Mexico

The adoption of a zero-rate provision in the U.S.-Australia treaty relationship may have particular ramifications for the U.S.-Mexico treaty relationship. Under the current U.S.-Mexico income tax treaty, dividends beneficially owned by a company that owns at least 10 percent of the voting stock of the dividend-paying company are subject to a maximum withholding rate of 5 percent (paragraph 2(a) of Article 10 of the U.S.-Mexico treaty), which is the lowest rate of withholding tax on dividends currently available under U.S. treaties. Under Protocol 1 to that treaty, as modified by a formal understanding subject to which the treaty and protocol were ratified, the United States and Mexico have agreed, if the United

[7] More broadly, since the U.S. Model has not been updated since 1996, the Committee may wish to ask whether the Treasury Department intends to update the model to reflect all relevant developments that have occurred in the intervening years. A thoroughly updated model would provide a more meaningful and useful guide to current U.S. tax treaty policy and would thereby increase transparency and facilitate Congressional oversight in this important area. *See* 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, at 445–47 (recommending that the Treasury Department revise U.S. model tax treaties once per Congress).

States adopts a rate on dividends lower than 5 percent in a treaty with another country, "to promptly amend [the U.S.-Mexico treaty] to incorporate that lower rate."[8]

Adopting the zero-rate provision in the proposed protocol with Australia would trigger this obligation to amend the current treaty with Mexico. The recently signed proposed protocol with Mexico would amend that treaty to incorporate a zero-rate provision substantially identical to that of the proposed treaty with the United Kingdom, and substantially similar to that of the proposed protocol with Australia, and thus would seem to fulfill the U.S. obligation under the "most favored nation" agreement. Thus, if the Senate were to ratify both the proposed protocol with Australia and the proposed protocol with Mexico, no issues of interaction between the two treaty relationships would need to be confronted.

If, on the other hand, the Senate were to ratify the proposed protocol with Australia, but not the proposed protocol with Mexico, then the possibility would arise that the United States eventually could be regarded as falling out of compliance with its obligations under the U.S.-Mexico treaty. This would raise difficult questions as to the exact nature of this obligation and whether and how the United States would come into compliance with it.

B. Income from the Rental of Ships and Aircraft

The present treaty includes a provision found in the U.S. model and many U.S. income tax treaties under which profits from an enterprise's operation of ships or aircraft in international traffic are taxable only in the enterprise's country of residence.

The present treaty and the proposed protocol differ from the U.S. model in the case of profits derived from the rental of ships and aircraft on a bareboat basis (*i.e.,* without crew). Under the proposed protocol, the rule limiting the right to tax to the country of residence applies to such rental profits only if the lease is merely incidental to the operation of ships and aircraft in international traffic by the lessor. If the lease is not merely incidental to the international operation of ships and aircraft by the lessor, then profits from rentals on a bareboat basis generally would be taxable by the source country as business profits (if such profits are attributable to a permanent establishment).

In contrast, the U.S. model and many other treaties provide that profits from the rental of ships and aircraft operated in international traffic on a bareboat basis are taxable only in the country of residence, without requiring that the lease be incidental to the international operation of ships and aircraft by the lessor. Thus, unlike the U.S. model, the proposed protocol provides that an enterprise that engages only in the *rental* of ships and aircraft on a bareboat basis, but does not engage in the *operation* of ships and aircraft, would not be eligible for the rule limiting the right to tax income from operations in international traffic to the enterprise's country of residence. It should be noted that, under the proposed

[8] This formal understanding was a response to an objection raised by the Committee to the original language of the treaty protocol, under which the "most-favored nation" provision would have been self-executing—i.e., immediately upon U.S. agreement to a lower rate with another treaty partner, the United States and Mexico would have begun applying that lower rate in their treaty.

protocol, 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. The Committee may wish to consider whether the proposed protocol's rules treating profits from certain rentals of ships and aircraft on a bareboat basis less favorably than profits from the operation of ships and aircraft (or from the rental of ships and aircraft with crew) are appropriate.

C. Capital Gains Tax

Unlike the U.S. model, the proposed protocol does not provide significant limits on Australia's ability to impose its capital gains tax on U.S. persons. In the United States, at death certain individuals are subject to the estate tax on the net value of assets in their estate, but accrued, but unrealized, capital gains are not subject to income tax. An heir's basis of an asset received by bequest is stepped up to the fair market value of the asset at the time of the decedent's death. Australia does not impose an estate tax, but an heir's basis of an asset received by bequest generally is the decedent's basis in the asset (carryover basis). Thus, if an heir sells the bequeathed asset upon receipt, there is a capital gains tax liability. As a consequence, a U.S. person's Australian assets could be subject to estate taxation in the United States upon his or her death and the heir could be liable for capital gains tax in Australia upon the sale of the bequeathed asset, creating a substantial aggregate tax liability without relief under the treaty. Australia enacted the carryover basis regime, in part, as a replacement for Australia's previous estate tax. Because the Australian capital gains tax serves some of the role of the U.S. estate tax, the Committee may want to consider the proper manner for coordination of treaty provisions relating to the taxation of capital gains under the proposed protocol with estate taxation in light of the present treaty in force with Australia with respect to estate taxes.

D. Visiting Teachers and Professors

The proposed protocol maintains the present treaty's treatment of visiting teachers and professors, in which an individual visiting in the host country to engage in teaching or research at an educational institution is subject to income tax in the host country on any remuneration received for his or her teaching or research. The treatment of the present treaty conforms to the U.S. model. 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. Although the proposed protocol with Mexico would not include such a provision, the proposed treaty with the United Kingdom does include such a provision, and three of the most recently ratified income tax treaties did contain

such a provision.[9] The Committee may wish to satisfy itself that the inclusion of such an exemption is not appropriate.

[9] The treaties with Italy, Slovenia, and Venezuela, each considered in 1999, 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.