# EXPLANATION OF THE PROPOSED INCOME TAX TREATY BETWEEN THE UNITED STATES AND THE PEOPLE'S REPUBLIC OF BANGLADESH

Scheduled for a Hearing

Before the

COMMITTEE ON FOREIGN RELATIONS
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# INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, describes the proposed income tax treaty between the United States and the People's Republic of Bangladesh, as supplemented by an exchange of diplomatic notes (the "notes"). The proposed treaty and notes were signed on September 26, 2004. Unless otherwise specified, the proposed treaty and the notes are hereinafter referred to collectively as the "proposed treaty." The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed treaty for February 2, 2006.[2]

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

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of the Proposed Income Tax Treaty Between the United States and the People's Republic of Bangladesh* (JCX-4-06), January 26, 2006.

[2] For a copy of the proposed treaty, *see* Senate Treaty Doc. 109-5.

# I. SUMMARY

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

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

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

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

The proposed treaty also contains a detailed limitation-on-benefits provision to prevent the inappropriate use of the treaty by third-country residents (Article 17).

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

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

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

## A. U.S. Tax Rules

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

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

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

Specific statutory exemptions from the 30-percent withholding tax are provided. For example, certain original issue discount and certain interest on deposits with banks or savings institutions are exempt from the 30-percent withholding tax. An exemption also is provided for certain interest paid on portfolio debt obligations. In addition, income of a foreign government or international organization from investments in U.S. securities is exempt from U.S. tax.

U.S.-source capital gains of a nonresident alien individual or a foreign corporation that are not effectively connected with a U.S. trade or business generally are exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien individual who is present in the

United States for at least 183 days during the taxable year; and (2) certain gains from the disposition of interests in U.S. real property.

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

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

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

## B. U.S. Tax Treaties

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

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

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

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

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

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

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

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

# III. OVERVIEW OF BANGLADESH TAX LAWS[3]

## A. National Income Taxes

**Overview**

Bangladesh imposes income tax on net income at the national level. The definition of income subject to tax is expansive and includes most capital gains. Taxable business income is based on accounting income, adjusted for nondeductible expenses and statutory allowances. Bangladesh offers several tax incentives, including tax holidays specified by the National Board of Revenue and reduced tax rates for specific categories of income and investors.[4]

**Individuals**

Individuals resident in Bangladesh are subject to tax on their worldwide income. For most types of income, individual rate brackets are generally progressive from zero to 25 percent. Capital gains are generally subject to tax at progressive rates from zero to 15 percent. Dividends and interest are generally are taxable to residents at a rate of 10 percent.

**Companies**

Companies resident in Bangladesh are subject to tax on their worldwide income. The general rate applicable for publicly traded companies having a registered office in Bangladesh and regularly distributing certain required dividends is 30 percent. The general rate for all other companies, including nonresident companies, is 40 percent. Banks, insurance companies, and other financial institutions are subject to income tax at a rate of 45 percent and to an excess profits surtax of 15 percent on profits exceeding 50 percent of capital and reserves. Dividends generally are subject to a withholding tax of 10 percent.

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[3] The information in this section relates to foreign law and is based on the Joint Committee staff's review of publicly available secondary sources. The description is intended to serve as a general overview; it may not be fully accurate in all respects, as many details have been omitted and simplifying generalizations made for ease of exposition. Major law changes under the Bangladesh proposed budget for fiscal year 2004–05, applicable from July 1, 2004, are noted.

[4] The 2004-2005 fiscal year tax holiday provision expired on June 30, 2005. However, it has been extended for three years for some sectors to June 30, 2008. These sectors include textiles, pharmaceuticals, ceramics, fertilizers, ship building, container terminal and depots, computer hardware, and steel.

## B. International Aspects Under Domestic Bangladesh Law

**<u>Residency</u>**

Generally, resident individuals and companies are subject to income tax on their worldwide income, while nonresident individuals and companies are subject to tax only on their income from sources in Bangladesh. Individuals are generally resident for tax purposes if they are present for 182 days or more in a tax year, or are present in Bangladesh for more than 90 days in a tax year and have been present in Bangladesh for a total of more than 364 days during the four preceding tax years. However, noncitizen technicians employed in Bangladesh are exempted from tax on their salaries for the first three years of employment upon approval by the tax department provided that the salaries are not taxed outside Bangladesh. After this three-year period, such individuals may be considered residents and taxed on their worldwide income. An employee present in Bangladesh for fewer than 182 days in a tax year is exempt from income tax on a salary received from an employer having the same country of residence, provided that the salary is not paid by a permanent establishment and neither taxed outside Bangladesh nor deducted from the employer's taxable income in Bangladesh. A company is resident in Bangladesh if it is registered under the laws of Bangladesh or if the control and management of its business are exercised in Bangladesh.

**<u>Sources of income</u>**

Income from sources in Bangladesh includes income derived from services rendered and activities carried out in Bangladesh, income from sales of property located within Bangladesh, and income reasonably attributable to the conduct of a business within Bangladesh. The concept of a "permanent establishment" is not used in Bangladesh internal tax law except in connection with the disallowance of an exemption from income tax for short-term foreign workers' income earned there.

**<u>Nonresident withholding</u>**

Nonresident individuals are generally subject to tax on Bangladesh-source income at a rate of 25 percent without allowance of deductions, exemptions or other relief. Nonresident companies are subject to tax on Bangladesh-source income at a rate of 40 percent without allowance of tax credits.

Bangladesh imposes and requires withholding of tax on dividends paid by resident companies to nonresident companies at a rate of 40 percent. Dividends paid to nonresident individuals are subject to withholding tax at a rate of 25 percent.

Bangladesh-source interest payments to nonresident corporations generally are subject to withholding tax at a rate of 40 percent. Interest payments to nonresident individuals are generally subject to withholding tax at a rate of 25 percent. As with dividends, the withholding tax rate is the income tax rate applicable to the recipient.

Bangladesh-source royalties and technical assistance fees paid to nonresident individuals or nonresident companies are subject to a 10-percent withholding tax.

In the absence of a treaty, Bangladesh generally provides double tax relief by way of a credit against Bangladesh tax.

### C. Other Taxes

In addition to the taxes described above, other taxes are levied at the national level. A value-added tax is imposed at a standard 15 percent rate, which is reduced to 1.5 percent for all sales of goods in metropolitan and municipal areas. A turnover tax is imposed on local products and services at a rate of four percent if total annual turnover is less than 2 million taka (approximately $30,000).[5] Excise taxes are imposed upon certain luxury goods and services, vehicles, natural gas, liquor, cigarettes and certain other goods and services. A stamp tax of 10 percent is imposed upon transfers of real property. Duties of 7.5 to 25 percent are imposed upon exports. Gross receipts of nonresident air transport companies, nonresident shipping companies, and nonresident companies engaged in oil exploration are taxed at rates of three percent, eight percent, and 3.75 percent respectively.

[5] This U.S. dollar equivalent was calculated using an exchange rate of 66 Bangladesh taka to one U.S. dollar.

## IV. EXPLANATION OF PROPOSED TREATY

### Article 1. Personal Scope

In general

The personal scope article describes the persons who may claim the benefits of the proposed treaty. The proposed treaty generally applies to residents of the United States and to residents of Bangladesh, with specific modifications. The determination of whether a person is a resident of the United States or Bangladesh is made under the provisions of Article 4 (Fiscal Domicile).

Saving clause

Like all U.S. income tax treaties and the U.S. model, the proposed treaty includes a "saving clause." Under this clause, with specific exceptions described below, the proposed treaty does not affect the taxation by either treaty country of its residents or its citizens. By reason of this saving clause, unless otherwise specifically provided in the proposed treaty, the United States will continue to tax its citizens who are residents of Bangladesh as if the treaty were not in force.

As in other U.S. income tax treaties, the saving clause in the proposed treaty contains a provision under which the saving clause (and therefore U.S. taxing jurisdiction to the full extent of U.S. internal law in most respects) applies to a former U.S. citizen or long-term resident whose loss of citizenship or resident status had as one of its principal purposes the avoidance of U.S. income tax.[6] The term "long-term resident" means any individual who was a lawful permanent resident of the United States for eight or more of the preceding 15 taxable years.[7] This provision was included to allow the United States to apply its special expatriation tax regime, set forth in section 877 of the Code.[8]

First enacted in 1966, this regime was designed to reduce opportunities for U.S. citizens to renounce their citizenship for the purpose of avoiding U.S. taxes. The regime has the main effect of expanding the scope of income that is subject to taxation by the United States, such that a former citizen or long-term resident to whom the rules apply is subject to U.S. tax on a

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[6] Although included in the proposed treaty in order to accommodate U.S. internal law, this provision is reciprocal, and thus could apply in a case involving a former citizen or long-term resident of Bangladesh. This description focuses on the impact of the provision with respect to the U.S. tax rules.

[7] An individual is not treated as a lawful permanent resident for any taxable year if such individual is treated as a resident of a foreign country for such year under the provisions of a tax treaty between the United States and the foreign country and the individual does not waive the benefits of such treaty applicable to residents of the foreign country.

[8] The Code also includes special expatriation-related rules for purposes of the estate and gift taxes. *See* Code secs. 2107 and 2501(a)(3). References to the "Code" are to the U.S. Internal Revenue Code of 1986, as amended.

somewhat broader basis than other nonresident aliens, but still on a narrower basis than a current U.S. citizen or resident. This special tax treatment applies for a period of 10 years, and thus the provision of the proposed treaty applies only for the 10-year period following the loss of U.S. citizenship or termination of residency.

Substantial changes to the special expatriation rules were included in the American Jobs Creation Act of 2004 ("AJCA"), which was signed into law on October 22, 2004 (roughly one month after the proposed treaty was signed, on September 26, 2004). The proposed treaty thus does not reflect these recent changes.

AJCA eliminated prior law's subjective determinations of tax-avoidance purpose and replaced them with objective rules for determining the applicability of the special tax regime for expatriates. Under the regime as amended by AJCA, a former citizen or former long-term resident is subject to the special income, estate, and gift tax rules for expatriates unless the individual: (1) establishes that his or her average annual net income tax liability for the five preceding years does not exceed $124,000 (adjusted for inflation after 2004) and his or her net worth is less than $2 million, or alternatively satisfies limited, objective exceptions for dual citizens and minors who have had no substantial contact with the United States; and (2) certifies under penalties of perjury that he or she has complied with all Federal tax obligations for the preceding five years and provides such evidence of compliance as the Treasury Secretary may require. Thus, as a result of AJCA, the application of the expatriation tax regime no longer turns on determinations of whether a person had a principal purpose of tax avoidance, as it often did prior to AJCA.

The Treasury Department's technical explanation of the proposed treaty ("Technical Explanation") notes that while AJCA eliminated the ruling process and the "tax avoidance purpose" language in section 877, it retained the objective net worth and net income tax tests. According to the Treasury Department, the objective tests in section 877 represent the administrative means by which the United States determines whether a taxpayer has a tax avoidance purpose for purposes of reserving the taxing rights contained in the saving clause. The Technical Explanation maintains that section 877, as amended by AJCA, is consistent with paragraph 2 of Article 29 and paragraph 2 allows the United States to exercise its full taxing jurisdiction with respect to former citizens and long-term residents.

Exceptions to saving clause

Exceptions to the saving clause are provided for the following benefits conferred by a treaty country: the allowance of correlative adjustments when the profits of an associated enterprise are adjusted by the other country (Article 9, paragraph 2); the exemption from source- and residence-country tax for certain public pension, social security, alimony, and child support payments (Article 19, paragraphs 2 and 5); relief from double taxation through the provision of a foreign tax credit (Article 23); protection from discriminatory tax treatment with respect to transactions with residents of the other country (Article 24); and benefits under the mutual agreement procedures (Article 25). These exceptions to the saving clause permit residents or citizens of the United States or Bangladesh to obtain such benefits of the proposed treaty with respect to their country of residence or citizenship.

In addition, the saving clause does not apply to certain benefits conferred by one of the countries upon individuals who neither are citizens of that country nor have been admitted for permanent residence in that country. Under this set of exceptions to the saving clause, the specified treaty benefits are available to, for example, a citizen of Bangladesh who spends enough time in the United States to be taxed as a U.S. resident but who has not acquired U.S. permanent residence status (i.e., does not hold a "green card"). The benefits that are covered under this set of exceptions are the exemptions from host-country tax for certain compensation from government service (Article 20), certain income received by visiting students and trainees (Article 21), and the income of diplomatic agents and consular officers (Article 27).

**Article 2. Taxes Covered**

The proposed treaty generally applies to the income and capital gains taxes of the United States and Bangladesh. Article 24 (Nondiscrimination) of the proposed treaty, however, is applicable to all taxes imposed at all levels of government, including state and local taxes.

In the case of the United States, the proposed treaty applies to the Federal income taxes imposed by the Code; it does not apply to social security taxes. In the case of Bangladesh, the proposed treaty applies to the income tax, including any surcharges that are calculated by reference to income taxes.

The proposed treaty also will apply to any taxes that are identical or substantially similar to the taxes described in the preceding paragraph and that are imposed after the signing of the proposed treaty in addition to or in place of existing taxes. This provision generally is found in U.S. income tax treaties. The proposed treaty obligates the competent authority of each country to notify the competent authority of the other country of any changes in its internal taxation or other laws that significantly affect a country's obligations under the proposed treaty. The Technical Explanation states that the use of the term "significantly" means that a change must be reported if it is significant to the operation of the proposed treaty.

**Article 3. General Definitions**

Article 3 defines several terms used in the treaty. Certain of the standard definitions found in most U.S. income tax treaties are included in the proposed treaty.

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

A "company" under the proposed treaty is any body corporate or any entity that is treated as a body corporate for tax purposes under the laws of the Contracting State in which it is organized or has its place of effective management.

The terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean, respectively, an enterprise carried on by a resident of a treaty country and an enterprise carried on by a resident of the other treaty country. The term "enterprise" is not defined in the proposed treaty, but the Technical Explanation states that, as under the OECD model, the term refers to the carrying on of any business. In contrast with the definitions in the U.S. model, the proposed treaty's definitions of "enterprise of a Contracting State" and "enterprise of the other Contracting State" do not explicitly refer to fiscally transparent enterprises. The Technical Explanation, however, states that the terms encompass an enterprise conducted through an entity (such as a partnership) that is treated as fiscally transparent in the country in which the entity's owner is resident.

The proposed treaty defines "international traffic" as any transport by a ship or aircraft, except when the transport is solely between places in a treaty country. Accordingly, as described in the Technical Explanation, the carriage of goods solely between, for example, New York and Chicago by either a U.S. or a Bangladesh carrier does not constitute international traffic.

The U.S. "competent authority" is the Secretary of the Treasury or his delegate. The U.S. Secretary of the Treasury has delegated the competent authority function to the Commissioner of Internal Revenue, who in turn has delegated the authority to the Director, International. On interpretative issues, the latter acts with the concurrence of the Associate Chief Counsel (International) of the IRS. The Bangladesh "competent authority" is the National Board of Revenue or its authorized representative.

The term "United States" means the United States of America, including the States thereof and the District of Columbia, but does not include Puerto Rico, the Virgin Islands, Guam, or any other U.S. possession or territory. The term is defined to include the territorial sea, and the sea bed and subsoil of the submarine areas adjacent to that territorial sea, over which the United States exercises sovereign rights in accordance with international law. According to the Technical Explanation, the extension of the definition to include certain sea and undersea areas generally applies to the extent that the United States exercises its sovereignty over those areas for natural resource exploration and exploitation, but only if the person, property, or activity to which the proposed treaty is being applied is connected with that exploration or exploitation.

The term "Bangladesh" means the People's Republic of Bangladesh. The term is defined to include the territorial sea, and the sea bed and subsoil of the submarine areas adjacent to that territorial sea, over which Bangladesh exercises sovereign rights in accordance with international law.

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

The proposed treaty includes the standard provision that, unless the context otherwise requires or the competent authorities agree upon a common meaning under Article 25 (Mutual Agreement Procedure), any term not defined in the proposed treaty has the meaning that it has under the tax laws of the country that is applying the treaty.

## Article 4. Fiscal Domicile

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

Internal taxation rules

United States

Under U.S. law, the residence of an individual is important because a resident alien, like a U.S. citizen, is taxed on his or her worldwide income, while a nonresident alien is taxed only on certain U.S.-source income and on income that is effectively connected with a U.S. trade or business. An individual who spends sufficient time in the United States in any year or over a three-year period generally is treated as a U.S. resident. A permanent resident for immigration purposes (that is, a "green card" holder) also is treated as a U.S. resident.

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

Bangladesh

Under Bangladesh law, resident individuals and companies generally are subject to income tax on their worldwide income. By contrast, nonresident individuals and companies generally are subject to Bangladesh tax only on their Bangladesh-source income.

Individuals generally are Bangladesh residents for tax purposes if they are present in Bangladesh for 182 days or more in a tax year, or are present in Bangladesh for more than 90 days in a tax year and have been present in Bangladesh for a total of more than 364 days during the four preceding tax years.

Upon approval by the Bangladesh tax authorities, noncitizen technicians employed in Bangladesh may be exempt from Bangladesh tax on their salaries for the first three years of employment if the salaries are not taxed outside Bangladesh. After this three-year period, noncitizen technicians may be considered residents and will be taxed by Bangladesh on their worldwide income. An employee present in Bangladesh for fewer than 182 days in a tax year is exempt from income tax on a salary received from an employer having the same country of residence, provided that the salary is not paid by a Bangladesh permanent establishment and is neither taxed outside Bangladesh nor deducted from the employer's taxable income in Bangladesh.

A company is resident in Bangladesh if it is registered under the laws of Bangladesh or if the control and management of its business are exercised in Bangladesh.

Proposed treaty rules

Article 4 provides rules to determine whether a person is a resident of the United States or Bangladesh under the proposed treaty. The rules generally are consistent with the rules of the U.S. model.

The proposed treaty generally defines "resident of a Contracting State" to mean any person who, under the laws of that State, is liable to tax in that State by reason of the person's domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature. The term "resident of a Contracting State" does not include any person who is liable to tax in that State only on income from sources in that State. Accordingly, although not explicitly stated in the proposed treaty, an enterprise of Bangladesh with a permanent establishment in the United States does not become a resident of the United States as a result of its U.S. permanent establishment: The enterprise generally is liable to tax by the United States only on income attributable to its U.S. permanent establishment, not on its worldwide income.

The proposed treaty makes explicit the generally understood practice of including in the definition of "resident of a Contracting State" the government of that State and any political subdivision or local authority of that State.

The proposed treaty provides special rules to treat as a resident of a treaty country an organization that is generally exempt from tax in that country and that is established and maintained (1) exclusively for a religious, charitable, educational, scientific or other similar purpose; or (2) to provide pensions or other similar benefits to employees pursuant to a plan.

The proposed treaty provides a series of tie-breaker rules to determine residence in the case of an individual who, under the basic residence definition, would be considered to be a resident of both countries. These tie-breaker rules are to be applied in the order in which they are described below. Under these rules, an individual is deemed to be a resident of the country in which he or she has a permanent home available. If the individual has a permanent home in both countries or in neither country, the individual's residence is deemed to be the country with which his or her personal and economic relations are closer (that is, the individual's "center of vital interests"). If it cannot be determined in which country the individual has his or her center of vital interests, the individual is deemed to be a resident of the country in which he or she has an habitual abode. If the individual has an habitual abode in both countries or in neither country, the individual is deemed to be a resident of the country of which he or she is a national. If the individual is a national of both countries or of neither country, the competent authorities of the countries will settle the question of residence by mutual agreement.

The proposed treaty also provides a tie-breaker rule for dual-resident companies. If, under the general residence rules described above, a company is a resident of both the United States and Bangladesh, the company is treated as a resident of the country under the laws of which it is organized or created. The following example illustrates the operation of this tie-breaker rule. A company is treated as a resident of the United States if it is created or organized under the laws of the United States or a political subdivision. Under Bangladesh law, a company is treated as a resident of Bangladesh if it is either incorporated there or managed and controlled there. Dual residence, therefore, can arise in the case of a company that is organized in the United States and is managed and controlled in Bangladesh. The tie-breaker rule provides that the residence of such a company would be in the country under the laws of which it is created or organized (in the example, the United States).

If, under the general residence rules described previously, a person other than an individual or company is a resident of both countries, the proposed treaty requires the competent authorities to endeavor to settle the issue of residence by mutual agreement and to determine the mode of application of the proposed treaty to that person.

Fiscally transparent entities

The proposed treaty sets forth a special residence rule for partnerships, trusts, and estates (fiscally transparent entities). Under this rule, income derived through an entity that is a partnership, trust, or estate under the laws of either treaty country is considered to be the income of a resident of one of the treaty countries only to the extent that the income is subject to tax in that country as the income of a resident. For example, if a Bangladesh company pays interest to an entity that is treated as fiscally transparent for U.S. tax purposes, the interest will be considered to be derived by a resident of the United States only to the extent that U.S. tax laws treat one or more U.S. residents (whose status as U.S. residents is determined under U.S. tax laws) as deriving the interest income for U.S. tax purposes.

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

## Article 5. Permanent Establishment

The proposed treaty contains a definition of the term "permanent establishment" that generally follows the pattern of other recent U.S. income tax treaties, the U.S. model, and the OECD model. The definition, however, also includes deviations from the U.S. and OECD models. These deviations are described below and are discussed separately in Part V of this pamphlet, dealing with developing-country concessions.

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

In general, under the proposed treaty, a permanent establishment is a fixed place of business through which the business of an enterprise is wholly or partly carried on. A permanent establishment includes a place of management, a branch, an office, a factory, a workshop, a store or other sales outlet, a warehouse in relation to a person providing storage facilities for others, and a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources. It also includes a building site, a construction or assembly project, or an installation or drilling rig used for the exploration of natural resources, if the site, project, or activity lasts for more than 183 days. The Technical Explanation states that the 183-day test applies separately to each site or project, with a series of contracts or projects that are interdependent both commercially and geographically treated as a single project. The Technical Explanation further states that if the 183-day threshold is exceeded, the site or project constitutes a permanent establishment as of the first day of the activity. These rules are similar to the rules in the U.S. model, but the U.S. model uses a threshold of 12 months instead of 183 days. The 183-day threshold is consistent with the U.N. model and with other treaties that the United States has concluded with developing countries.

Under the proposed treaty, the following activities are deemed not to constitute a permanent establishment: (1) the use of facilities solely for storing or displaying goods or merchandise belonging to the enterprise; (2) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for storage or display or solely for processing by another enterprise; and (3) the maintenance of a fixed place of business solely for the purchase of goods or merchandise or for the collection of information for the enterprise. The proposed treaty also provides that the maintenance of a fixed place of business solely for the purpose of carrying on any other activity of a preparatory or auxiliary character does not constitute a permanent establishment. The proposed treaty further provides that no combination of the excepted activities described above will give rise to a permanent establishment, provided the overall activity of the fixed place of business resulting from the combination is of a preparatory or auxiliary character. This rule is similar to the rule in the U.S. model except that the U.S. model (unlike the OECD model) does not include the additional preparatory or auxiliary requirement.

Unlike the U.S. model (but like the U.N. model), the proposed treaty does not exclude from permanent establishment status the use of facilities or the maintenance of a stock of goods solely for the purpose of delivery. The proposed treaty, however, includes a separate rule that the term "permanent establishment" does not include the use of facilities or the maintenance of a stock of goods or merchandise belonging to the enterprise for the purpose of "occasional delivery" of the goods or merchandise. The Technical Explanation states that a permanent establishment does exist if deliveries are made on a regular basis from a warehouse or other storage facility.

The proposed treaty sets forth two circumstances in which a dependent agent of an enterprise constitutes a permanent establishment of the enterprise. First, a dependent agent acting in a treaty country on behalf of an enterprise of the other country is a permanent establishment in the first country if the agent has, and habitually exercises in that first country, the authority to conclude contracts in the name of the enterprise. This rule does not apply where the activities are limited to the preparatory and auxiliary activities described in the two preceding paragraphs. Second, even if a dependent agent of an enterprise of one treaty country has no authority to conclude contracts, the dependent agent will give rise to a permanent establishment of the enterprise in the second treaty country if the agent maintains in the second treaty country a stock of goods or merchandise from which the agent regularly fills orders or makes deliveries on behalf of the enterprise, and additional activities conducted in the first treaty country on behalf of the enterprise have contributed to the conclusion of the sale of the goods or merchandise. This second provision is a departure from the U.S. model but is similar to a provision in the U.N. model.

Under the proposed treaty, an enterprise is not treated as having a permanent establishment in a treaty country merely because it carries on business in that country through a broker, general commission agent, or any other agent of independent status, provided that the agent is acting in the ordinary course of its business. The Technical Explanation states that whether an enterprise and an agent are independent is a factual determination and that the relevant factors in making this determination include the extent to which the agent operates on the basis of instructions from the enterprise; the extent to which the agent bears business risk; and whether the agent has an exclusive or nearly exclusive relationship with the enterprise.

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

## Article 6. Income From Immovable Property

This article covers income from immovable property. The rules covering gains from the sale of immovable property are included in Article 13 (Capital Gains). Under the proposed treaty, income derived by a resident of one country from real property situated in the other country may be taxed in the country where the property is situated. This rule and, in general, the other rules of this article are consistent with the rules in the U.S. and OECD models.

The Technical Explanation states that the term "immovable property" is intended to have the same meaning as the term "real property." The term "immovable property" is the term used in the OECD model.

The term "real property" generally has the meaning that it has under the law of the country in which the property in question is situated.[9] The proposed treaty provides that income from real property includes income from property accessory to real property, livestock and equipment used in agriculture, forestry, and fishery, rights to which the provisions of general law respecting real property apply, usufruct of real property, and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits and other natural resources. Ships, boats, aircraft, and containers are not regarded as real property. The inclusion in Article 6 of income from equipment used in fishery is worthy of note because it does not appear in any U.S. tax treaty, although it does appear in several Bangladesh tax treaties.

The proposed treaty specifies that the country in which the property is situated also may tax income derived from the direct use, letting, or use in any other form of real property. The

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[9] In the case of the United States, according to the Technical Explanation, the term "real property" has the meaning given to it by Treas. Reg. sec. 1.897-1(b).

rules of this Article, permitting source-country taxation, also apply to the income from real property of an enterprise and to income from real property used for the performance of independent personal services.

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

## Article 7. Business Profits

### Internal taxation rules

#### United States

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

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

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

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

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

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

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

Bangladesh

Nonresident individuals and companies generally are subject to tax in Bangladesh only on income from Bangladesh sources.

Nonresident individuals are generally subject to tax on Bangladesh-source income at a rate of 25 percent without allowance of deductions, exemptions, or other relief. Nonresident companies generally are subject to tax on Bangladesh-source income at a rate of 40 percent without allowance of tax credits.

Proposed treaty limitations on internal law

Under the proposed treaty, business profits of an enterprise of a treaty country are taxable in the other treaty country only to the extent that they are attributable to a permanent establishment in the other country through which the enterprise carries on business. This rule is one of the basic treaty limitations on a country's right to tax income of a resident of the other country. The rule is similar to the rules found in the U.S. and OECD models.

The proposed treaty defines "business profits" as income derived from any trade or business carried on by an individual, a company, an enterprise, or any other person or group of persons. The term includes income from the rental of tangible personal property and the performance of personal services by an enterprise.

The Technical Explanation discusses significant features of the definition of "business profits." First, the inclusion in the definition of income of an enterprise from personal services is consistent with the long-standing U.S. position that an enterprise's personal services income is business profits. Accordingly, a consulting firm resident in one treaty country whose employees perform services in the other treaty country through a permanent establishment may be taxed in that other country under Article 7 (and not under Article 15 (Independent Personal Services) because that article applies only to individuals). Second, the term "business profits" includes income attributable to notional principal contracts and other financial instruments to the extent that the income is attributable to a trade or business of dealing in such instruments or is otherwise related to a trade or business (as in the case of a notional principal contract entered into for the purpose of hedging currency risk arising from an active trade or business). Any other income derived from financial instruments is, according to the Technical Explanation, addressed in Article 22 (Other Income), unless specifically governed by another article.

The proposed treaty provides rules for the attribution of business profits to a permanent establishment. Under these rules, the treaty countries will attribute to a permanent establishment the business profits that the permanent establishment might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions. The Technical Explanation states that this rule incorporates the arm's-length standard for purposes of determining the profits attributable to a permanent establishment.

The Technical Explanation discusses certain features of the proposed treaty's rules for attributing business profits to a permanent establishment. First, the "attributable to" inquiry is analogous to the "effectively connected" concept of Code section 864(c) described above. In particular, business profits are attributed to a permanent establishment only if the profits are derived from the permanent establishment's assets or activities -- a rule similar to the asset-use and business activities tests of Code section 864(c)(2). The limited force of attraction rule of Code section 864(c)(3) is not included in the proposed treaty rules. Second, the business profits article does not include a rule found in the OECD model under which a treaty country in certain circumstances may determine the profits attributable to a permanent establishment on the basis of an apportionment of the total profits of the enterprise. The Technical Explanation states that this rule is unnecessary because total profits apportionment is authorized even without the rule so long as the apportionment is designed to approximate an arm's-length result. Third, the exchange of notes between the United States and Bangladesh provides that if the information available to the tax authority of a treaty country is not sufficient to measure accurately the business profits of a permanent establishment, the determination of those profits may be made on a reasonable basis using available information, provided the determination seeks to reflect an arm's-length result.

The proposed treaty provides that in computing taxable business profits of a permanent establishment, deductions are allowed for expenses, wherever incurred, that are for the purposes of the permanent establishment. These deductions include a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole or the part of the enterprise that includes the permanent establishment. The Technical Explanation states that deductions are allowed regardless of which accounting unit of the enterprise books the expenses, so long as the expenses are incurred for the purposes of the permanent establishment. The Technical Explanation also states that this rule permits, but does not require, each treaty country to apply the type of expense allocation rules provided by U.S. internal law.[10]

Although the proposed treaty (like the U.S. model and unlike the U.N. model) does not explicitly address the issue, the Technical Explanation states that the proposed treaty does not permit a deduction for payments charged to a permanent establishment by another unit of the enterprise. Consequently, according to the Technical Explanation, a permanent establishment (1) may not deduct a royalty deemed to be paid to the head office and (2) may neither include in its business profits any notional fees for ancillary services performed for another unit of the enterprise nor take a deduction for the expense of providing those services.

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

The proposed treaty requires that the determination of the business profits of a permanent establishment be made using the same method year by year unless there is a good and sufficient reason to the contrary.

Where business profits include items of income that are dealt with separately in other articles of the proposed treaty, those other articles, and not the business profits article, generally govern the treatment of those items of income. Thus, for example, the taxation of dividends is determined under the rules of Article 10 (Dividends), and not by the rules of Article 7 (Business

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

Profits), except as specifically provided in Article 10 (that is, when dividends are attributable to a permanent establishment or a fixed base).

The proposed treaty provides that, for purposes of the taxation of business profits, income may be attributable to a permanent establishment (and therefore may be taxable in the source country) even if the payment of the income is deferred until after the permanent establishment or fixed base has ceased to exist. This rule incorporates into the proposed treaty the rule of Code section 864(c)(6) described above. This rule applies in the implementation of the rules for business profits (Article 7, paragraphs 1 and 2), dividends (Article 10, paragraph 5), interest (Article 11, paragraph 4), royalties (Article 12, paragraph 4), capital gains (Article 13, paragraph 2), independent personal services (Article 15), and other income (Article 22, paragraph 2).

The Technical Explanation notes that Article 7 is subject to the savings clause of paragraph 2 of Article 1 (Personal Scope), and to Article 17 (Limitation on Benefits). Thus, in the case of the savings clause, if a U.S. citizen who is a resident of Bangladesh derives business profits from the United States that are not attributable to a permanent establishment in the United States, the United States may tax those profits, notwithstanding that paragraph 1 of this article would exempt the income from U.S. tax.

## Article 8. Shipping and Air Transport

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

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

Paragraph 1 of Article 8 of the proposed treaty 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, regardless of the existence of a permanent establishment in the other country. "International traffic" is defined in Article 3(1)(d) (General Definitions) as any transport by a ship or aircraft, except where such transport is solely between places in a treaty country. The rule of paragraph 1 and the related definition are the same as those in the U.S. model, and include, for example, the carriage of passengers or goods by a Bangladesh carrier between a non-U.S. port and a U.S. port, even if there is an interim stop at a second U.S. port, and even if the leg between the two U.S. ports is overland and handled by an independent carrier under contract with the Bangladesh carrier, as long as both parts of the trip are reflected in the original bill of lading.

The proposed treaty provides that profits from the operation of ships or aircraft in international traffic include (in addition to profits derived directly) profits derived from the rental of ships or aircraft on a full (i.e., with crew, on a time or voyage basis) or bareboat basis of ships or aircraft if either (1) such ships or aircraft are operated in international traffic by the lessee, or (2) such rental profits are incidental to other profits of the lessor that are directly derived from the operation of ships or aircraft in international traffic. This provision is similar to that in the U.S. model. Unlike the OECD model, however, the provision covers non-incidental bareboat leasing.

The Technical Explanation states that certain non-transport activities that are an integral part of the services performed by a transport company are understood to be covered by Article 8, for example, the performance of some maintenance or catering services by one airline for another airline, if such services are incidental to the provision of those services by the airline for itself. However, income earned by concessionaires is not covered by Article 8.

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

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

The Technical Explanation notes that this article is subject to Article 23 (Limitation on Benefits), as well as the saving clause of paragraph 2 of Article 1 (General Scope). Thus, if a citizen of the United States who is a resident of Bangladesh derives profits from the operation of aircraft in international traffic, notwithstanding the exclusive residence country taxation in paragraph 1 of Article 8, the United States may, subject to the special foreign tax credit rules of paragraph 3 of Article 23 (Relief from Double Taxation), tax those profits as part of the worldwide income of the citizen. However, this situation is unlikely because non-tax considerations (e.g., insurance) generally result in shipping activities being carried on in corporate form.

**Article 9. Associated Enterprises**

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

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

Under the proposed treaty, when a redetermination of tax liability has been made by one country under the provisions of this article, the other country will make an appropriate adjustment to the amount of tax paid in that country on the redetermined income. In making such adjustment, due regard is to be given to other provisions of the proposed treaty. The proposed treaty's saving clause retaining full taxing jurisdiction in the country of residence or citizenship does not apply in the case of such adjustments. Accordingly, an internal statute of limitations would not prevent the allowance of appropriate correlative adjustments.

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

## Article 10. Dividends

### Internal taxation rules

#### United States

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

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

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 generally 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. However, the receipt of a distribution from a REIT is generally treated as a disposition of a U.S. real property interest by the recipient to the extent that it is attributable to a sale or exchange of a U.S. real property interest by the REIT[11] (see discussion of capital gains in connection with Article 13 below).

A REIT is generally 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. When rental income (or interest income) of a REIT is distributed to a foreign shareholder as a REIT dividend, it is treated as a dividend under U.S. internal law.

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. Dividends paid by a RIC are generally treated as dividends received by the payee, and the RIC generally pays no tax because it is permitted to deduct dividends paid to its shareholders in computing its taxable income. However, a RIC generally may pass through to its shareholders the character of its net long-term and, before January 1, 2008, net short-term, capital gains by designating a dividend it pays as a long-term or short-term capital gain dividend, to the extent that the RIC has such net capital gains. Nonresident aliens and foreign corporations are generally not subject to tax on capital gains. Notwithstanding, a distribution made by a RIC to a nonresident alien or a foreign corporation before January 1, 2008 is treated as gain recognized by such person from the sale or exchange of a U.S. real property interest to the extent such gain is attributable to gain from sales or exchanges of U.S. real property interests (see discussion of capital gains in connection with Article 13 below).

Similarly, a RIC that earns interest income that would not be subject to U.S. tax if earned by a foreign person directly ("qualified interest income")[12] may generally designate a dividend it

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[11] There is an exception for distributions to a shareholder that owns five percent or less of the REIT, if the REIT stock is regularly traded on an established securities market located in the United States. Sec. 897(h)(1). Such distributions are treated as dividends under U.S. internal law.

[12] Qualified interest income of the RIC is equal to the sum of its U.S.-source income with respect to: (1) bank deposit interest; (2) short term original issue discount that is currently exempt from the

pays prior to January 1, 2008 as derived from such interest income, to the extent of such income. Nonresident aliens and foreign corporations are not subject to tax on such interest-related dividends. The aggregate amount that may be designated by a RIC as interest-related dividends generally is limited to the sum of qualified interest income less the amount of expenses of the RIC properly allocable to such interest income.

Bangladesh

Bangladesh imposes and requires withholding of tax on dividends paid by resident companies to nonresident companies at a rate of 40 percent. Dividends paid to nonresident individuals are subject to withholding tax at a rate of 25 percent.

Proposed treaty limitations on internal law

Under the proposed treaty, dividends paid by a company that is a resident of a treaty country to a resident of the other country may be taxed in such other country. Such dividends also may be taxed by the country in which the payor company is resident (the "source country"), but the rate of such tax is limited. Under the proposed treaty, source-country taxation of dividends is generally limited to 15 percent of the gross amount of the dividends paid to residents of the other treaty country; except that source-country taxation of dividends is limited to 10 percent of the gross amount of dividends paid to a company that is resident in the other country and that owns 10 percent or more of the voting stock of the company paying the dividends. Such ownership may be direct or through tiers of companies, but only voting shares are taken into account for determining if the 10-percent threshold is met.

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

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

The 10-percent maximum withholding rate for large shareholders does not apply to dividends paid by a REIT or a RIC to a resident of Bangladesh. The 15-percent maximum treaty

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gross-basis tax under section 871; (3) any interest (including amounts recognized as ordinary income in respect of original issue discount, market discount, or acquisition discount under the provisions of sections 1271-1288, and such other amounts as regulations may provide) on an obligation which is in registered form, unless it is earned on an obligation issued by a corporation or partnership in which the RIC is a 10-percent shareholder or is contingent interest not treated as portfolio interest under section 871(h)(4); and (4) any interest-related dividend from another RIC.

rate of withholding tax is allowed for dividends paid by a RIC to a resident of Bangladesh. In the case of dividends paid by a REIT to a resident of Bangladesh, the 15-percent maximum rate of withholding tax is allowed only if one of three conditions is met: (1) the person beneficially entitled to the dividends is an individual holding an interest of not more than 10 percent in the REIT; (2) the dividends are paid with respect to a class of stock that is publicly traded, and the person beneficially entitled to the dividends is a person holding an interest of not more than five percent of any class of the REIT's stock; or (3) the person beneficially entitled to the dividends 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 interests in real property).

The Technical Explanation indicates that the restrictions on availability of the lower rates with respect to RICs and REITs are intended to prevent the use of these entities to gain unjustifiable source-country benefits for certain shareholders resident in Bangladesh. For example, a corporation resident in Bangladesh that wishes to hold a diversified portfolio of U.S. corporate shares may hold the portfolio directly and pay a U.S. withholding tax of 15 percent on all of the dividends that it receives. Alternatively, it may acquire a diversified portfolio by purchasing a 10-percent (or greater) interest in a RIC. Since the RIC may be a pure conduit, there may be no U.S. tax costs to interposing the RIC in the chain of ownership. Absent the special rule for RICs, such use of the RIC could transform portfolio dividends, taxable in the United States under the proposed treaty at 15 percent, into direct investment dividends taxable only at 10 percent.

For another example, a resident of Bangladesh directly holding U.S. real property would be required to pay U.S. tax either at a 30-percent rate on gross income or at graduated rates on the net income from the property. By placing the property in a REIT, the investor could transform real estate income into dividend income, taxable at the 10-percent rate provided in the proposed treaty. The limitations on REIT dividend benefits are intended to protect against this result.

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

The Technical Explanation notes that the saving clause of paragraph 2 of Article 1 (Personal Scope) permits the United States to tax dividends received by its residents and citizens, subject to the foreign tax credit rules of paragraph 3 of Article 23 (Relief from Double Taxation), as if the proposed treaty had not come into effect.

The benefits of the dividends article are also subject to the provisions of Article 17 (Limitation on Benefits). Thus, if a resident of Bangladesh is the beneficial owner of dividends paid by a U.S. company, the shareholder must qualify for treaty benefits under at least one of the tests of Article 17 in order to receive the benefits of the dividends article.

## Article 11. Interest

Internal taxation rules

United States

Subject to several exceptions (such as those for portfolio interest, bank deposit interest, and short-term original issue discount), the United States generally 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 generally 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 amount of interest paid by the 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 the interest (1) is paid on an obligation that satisfies certain registration requirements or specified exceptions to the requirements, and (2) is not received by a 10-percent owner of the issuer of the obligation, taking into account shares owned by attribution. The portfolio interest exemption does not, however, 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.

Bangladesh

Bangladesh-source interest payments to nonresident corporations generally are subject to withholding tax at a rate of 40 percent. Interest payments to nonresident individuals generally are subject to withholding tax at a rate of 25 percent.

Proposed treaty limitations on internal law

The proposed treaty provides that interest derived by a resident of a treaty country from sources within the other treaty country (the source country) generally may be taxed by both countries. This rule is contrary to the rule of the U.S. model that interest that is sourced in one treaty country and is beneficially owned by a resident of the other treaty country may be taxed only by the residence country.

The proposed treaty limits the rate of source-country tax that may be imposed on interest income. Under the proposed treaty, the source-country tax on interest derived and beneficially owned by a resident of the other treaty country generally may not exceed 10 percent of the gross amount of the interest. This rate is higher than the U.S. model rate of zero. The 10-percent source-country rate is modified for certain categories of interest. As described below, some categories are exempt from source-country tax and other categories are subject to source-country tax at a five percent rate. According to the Technical Explanation, the reduced source-country tax rates, and the exemption from source-country tax, may be granted at the time of payment through a reduction or elimination of withholding tax or at a subsequent time by a refund.

The term "beneficial owner" is not defined in the proposed treaty and therefore has the meaning given to it by the internal law of the country imposing the tax. According to the Technical Explanation, the beneficial owner of the interest is the person to which the interest income is attributable for tax purposes under the laws of the source country. Consequently, interest arising in one treaty country that is received by an agent that is a resident of the other country on behalf of a person who is not a resident of that other country is not entitled to the benefits of Article 11.

The proposed treaty provides a complete exemption from source-country tax for interest arising in a treaty country if (1) the interest is derived by the Government of the other treaty country or an instrumentality of the Government (including the Bangladesh Bank, the Federal Reserve Banks of the United States, the Export-Import Bank of the United States, and the Overseas Private Investment Corporation of the United States), or (2) the interest is on a debt obligation guaranteed or insured by the Government of that treaty country or an instrumentality of that Government. The proposed treaty provides a maximum source-country tax rate of five percent of the gross amount of the interest for interest arising in a treaty country and derived and beneficially owned by (1) a bank or other financial institution (including an insurance company) that is a resident of the other treaty country, or (2) a resident of the other treaty country in connection with a sale on credit to an enterprise of the source country of any industrial, commercial, or scientific equipment or of any merchandise.

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

The proposed treaty addresses the issue of non-arm's-length interest charges between related parties by stating that Article 11 applies only to the amount of arm's-length interest. Any amount of interest paid in excess of the arm's-length interest is taxable according to the laws of each country, taking into account the other provisions of the proposed treaty. For example, excess interest paid to a parent corporation may be treated as a dividend under local law and, thus, subject to the rules of Article 10 (Dividends). The Technical Explanation states that if the amount of interest paid by one person to another is less than the amount that would have been paid in the absence of the special relationship between the persons, a treaty country may characterize a transaction to reflect its substance and impute interest in a manner consistent with the definition of interest described above.

The proposed treaty defines "interest" as interest from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and, in particular, income from government securities and income from bonds or debentures, including premiums and prizes attached to the instruments. The term "interest" also includes an excess inclusion with respect to a REMIC, and it includes all other income that is treated as interest under the internal law of the country in which the income arises. As described in the Technical Explanation, amounts that the United States will treat as interest include original issue discount and imputed interest on a deferred sales contract. Interest does not, however, include income covered in Article 10 (Dividends).

The proposed treaty provides two anti-abuse exceptions to the general source-country reduction in tax described above. The first exception provides that the reductions in and exemption from source-country tax do not apply to excess inclusions with respect to a residual interest in a REMIC. That income may be taxed in accordance with each country's internal law. The second anti-abuse exception relates to "contingent interest" payments. Contingent interest paid by a source-country resident to a resident of the other country may be taxed in the source country in accordance with that country's internal laws if the interest is of a type that does not qualify as portfolio interest under U.S. law (or is of a similar type under the internal laws of Bangladesh).[13] If, however, the beneficial owner of the interest is a resident of the other country, the interest may not be taxed at a rate exceeding 15 percent (the rate prescribed in paragraph 2(b) of Article 10 (Dividends)).

The proposed treaty provides that interest is treated as arising in a treaty country if the payer is a resident of that country.[14] If, however, 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 Canadian resident has a permanent establishment in Bangladesh and that Canadian resident incurs indebtedness to a U.S. person, the interest on which is borne by the Bangladesh permanent establishment, the interest would be treated as having its source in Bangladesh.

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

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

## Article 12. Royalties

The proposed treaty retains source-country taxation of royalties but generally limits the maximum level of tax to 10 percent of the gross amount of a royalty.

### 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.

#### Bangladesh

Bangladesh generally imposes a 10-percent withholding tax on Bangladesh-source royalties and technical assistance fees paid to nonresident individuals or nonresident companies.

### Proposed treaty limitations on internal law

The proposed treaty provides that royalties derived by a resident of one treaty country from sources within the other treaty country may be taxed by both countries. The proposed treaty, however, limits to 10 percent of the gross amount of royalties the source country's taxation of royalties derived and beneficially owned by a resident of the other treaty country. This rule differs from the U.S. model rule. The U.S. model provides for a zero source-country rate.

The Technical Explanation states that the beneficial owner of a royalty payment (the person eligible for benefits under Article 12) is a person resident in a treaty country to whom that country attributes the payment for purposes of its tax.

The proposed treaty defines "royalties" as payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work, including cinematograph films or tapes used for radio or television broadcasting, and any patent, trademark, design, model, plan, secret formula or process, or other similar property or rights, or for information about industrial, commercial, or scientific experience. Gain from the disposition of any property or right described above constitutes royalty income to the extent that the amount realized on the disposition is contingent on the productivity, use, or further disposition of the property or right. The proposed treaty provides that royalties do not include any payments for the working of, or the right to work, mineral deposits, sources, and other natural resources. According to the Technical Explanation, royalties also do not include income from leasing personal property.

The reduced source country tax rate on royalties does not apply where the beneficial owner has a permanent establishment in the source country or performs independent personal services from a fixed base in the source country, and the right or property giving rise to the royalties is effectively connected with the permanent establishment or fixed base. In that case the royalties will be taxed as business profits (Article 7) or income from the performance of independent personal services (Article 15).

Under the proposed treaty, royalties are deemed to arise from a treaty country when the royalties are in consideration for the use of or the right to use in that country property, information, or experience. This rule is consistent with the place-of-use rule under internal U.S. law.

The proposed treaty provides that in the case of royalty payments between related persons, only the portion of the payment that represents an arm's-length royalty will be treated as a royalty under the treaty. Payments in excess of the arm's-length amount may be taxed according to the laws of each country with due regard being given for the other provisions of the treaty. Thus, for example, any excess amount might be treated as a dividend subject to the taxing limitations of Article 10 (Dividends).

## Article 13. Capital Gains

### Internal taxation rules of United States

Generally, gain realized by a nonresident alien or a foreign corporation from the sale of a capital asset is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S. trade or business. A regulated investment company ("RIC") generally may pass through to its shareholders the character of its net long-term and, before January 1, 2008, net short-term, capital gains by designating a dividend it pays as a long-term or short-term capital gain dividend, to the extent that the RIC has such net capital gains.

The Foreign Investment in Real Property Tax Act ("FIRPTA") extends the reach of U.S. taxation to dispositions of U.S. real property by foreign corporations and nonresident aliens.[15] Under FIRPTA, nonresident aliens and foreign corporations are subject to U.S. tax on their gains from the sale of U.S. real property interests, as if such gains were effectively connected with a trade or business conducted in the United States. "U.S. real property interests" generally include interests in certain corporations if at least 50 percent of the assets of the corporation consist of U.S. real property ("U.S. real property holding corporation"), except in the case of a "domestically controlled" real estate investment trust ("REIT") or (before January 1, 2008) RIC.[16] A distribution by a REIT and, before January 1, 2008, by a RIC, to a nonresident alien or a foreign corporation is generally treated as gain recognized by such person from the sale or exchange of a U.S. real property interest to the extent such gain is attributable to gain from sales or exchanges of U.S. real property interests. However, a distribution made by a REIT with respect to a class of stock publicly traded on an established securities market located in the

[15] FIRPTA contained a provision expressly overriding any tax treaty but generally delaying such override until after December 31, 1984. *See* Foreign Investment in Real Property Tax Act, Pub. L. No. 96-499, sec. 1125(c)(1) (1980).

[16] "Domestically controlled" REIT or RIC means one in which less than 50 percent of the value of the stock was held directly or indirectly by non-U.S. persons at all times during the testing period (generally the five-year period ending on the date of disposition).

United States is not treated as gain from the sale or exchange of a U.S. real property interest if the shareholder did not own more than five percent of the class of stock at any time during the taxable year.

Proposed treaty limitations on internal law

The proposed treaty specifies rules governing when a country may tax gains from the alienation of property by a resident of the other country. Generally, except as described below with respect to real property and certain other property, gains from disposition of any property are taxable only by the treaty country in which the alienator is resident.

Under the proposed treaty, gains derived by a resident of one treaty country from the alienation of immovable property situated in the other country may be taxed in the country in which the property is situated. For the purposes of this article, immovable property includes "immovable property" situated in a treaty country, as defined in Article 6 (Income From Immovable Property) of the proposed treaty. That definition has the same meaning which it has under the laws of the treaty country in which the property in question is situated, and specifically includes real property, property accessory to real property, livestock and equipment used in agriculture, forestry, and fishery, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property, and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources. In the case of the United States, immovable property also includes a United States real property interest. In the case of Bangladesh, immovable property also includes an interest in the capital stock of a company the assets of which consist principally of immovable property situated in Bangladesh.

Thus, the proposed treaty permits the United States to apply the FIRPTA rules to tax a resident of Bangladesh on the disposition of shares in a U.S. company that owns sufficient U.S. real property interests on certain testing dates to qualify as a U.S. real property holding corporation. The Technical Explanation states that in applying these rules, the United States will look through certain distributions made by a REIT or RIC. Accordingly, distributions made by a REIT or RIC are taxable under paragraph 1 of this article, and not under Article 10 (Dividends), when they are attributable to gains derived from the alienation of real property. However, a distribution made by a REIT with respect to a class of stock publicly traded on an established securities market located in the United States is not treated as gain from the sale or exchange of a U.S. real property interest if the shareholder did not own more than 5 percent of the class of stock during the taxable year.

The proposed treaty contains a provision that permits a treaty country to tax gains from the alienation of property (other than real property) that forms a part of the business property of a permanent establishment located in that country. The rule also applies to a fixed base located in a treaty country that is available to a resident of the other treaty country for the purpose of performing independent personal services. This rule also applies to gains from the alienation of such a permanent establishment (alone or with the enterprise as a whole) or such fixed base. The Technical Explanation states that a resident of Bangladesh that is a partner in a partnership doing business in the United States generally will have a permanent establishment in the United States as a result of the activities of the partnership, assuming that the activities of the partnership rise to the level of a permanent establishment.[17] The Technical Explanation further states that under this provision, the United States generally may tax a partner's distributive share of income realized by a partnership on the disposition of personal (movable) property forming part of the business property of the partnership in the United States.

The proposed treaty provides that gains derived by an enterprise carried on by a resident of a treaty country from the alienation of ships, aircraft, or containers operated in international traffic are taxable only in such country. According to the Technical Explanation, the inclusion of trailers, barges and related equipment for the transport of containers in the definition of containers in Article 8 (Shipping and Air Transport) also applies to this article.

Gains derived from the alienation of any right or property that produces income described in Article 12 (Royalties) are taxable only in accordance with Article 12. Such gains are those derived from the alienation of any right or property that gives rise to royalties that are contingent on the productivity, use, or disposition of such right or property.

Gains from the alienation of any property of a type other than those discussed above are taxable under the proposed treaty only in the country in which the person alienating the property is resident, to the extent that such gains are not otherwise characterized as income taxable under another article (e.g., Article 10 (Dividends), Article 11 (Interest), or Article 12 (Royalties)).

Notwithstanding the foregoing limitations of certain gains by the country of source, the saving clause of paragraph 2 of Article 1 (Personal Scope) permits the United States to tax its citizens and residents as if the treaty had not come into effect. The benefits of this article are also subject to the provisions of Article 17 (Limitation on Benefits). Thus, only a resident that satisfies one of the conditions in Article 17 is entitled to the benefits of this article.

## Article 14. Branch Tax

### Internal taxation rules

#### United States

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

If a U.S. branch of a foreign corporation has allocated to it an interest deduction in excess of the interest actually paid by the branch, such excess interest is treated as if it were paid on a

[17] *See* Rev. Rul. 91-32, 1991-1 C.B. 107.

notional loan to a U.S. subsidiary from its foreign corporate parent. This excess interest is subject to a 30-percent withholding tax absent a specific statutory exemption.

Bangladesh

According to the Technical Explanation, Bangladesh does not currently impose a branch profits tax or an excess interest tax on a foreign company with a branch in Bangladesh, but does impose a branch profit remittance tax.

Proposed treaty limitations on internal law

The proposed treaty allows a treaty country to impose a branch profits tax on a company resident in the other treaty country, in addition to the other taxes permitted under the proposed treaty.

The United States is allowed under the proposed treaty to impose its branch profits tax at a reduced rate of 10 percent on a Bangladesh corporation that 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 (other than an interest in a U.S. real property holding corporation). The tax is imposed on the dividend-equivalent amount, as defined in the Code (approximately 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 in which a Bangladesh corporation conducts a trade or business in the United States but not through a permanent establishment, the proposed treaty completely eliminates the branch profits tax that the Code would otherwise impose on such corporation (unless the corporation earned income from real property as described above).

Under the proposed treaty, Bangladesh is allowed to impose a branch profits tax (not to exceed a rate of 10 percent) in an amount sufficient to provide that a Bangladesh branch of a U.S. company or a U.S. company otherwise taxable on its net income in Bangladesh is taxed in a manner comparable to a similarly situated Bangladesh company and its U.S. shareholder. In practice, this will permit Bangladesh to impose its branch profit remittance tax at the rate of 10 percent.

The United States is also allowed under the proposed treaty to impose the branch excess interest tax, generally at a rate of 10 percent, the rate generally applicable under paragraph 2 of Article 11 to interest payments from U.S. sources to residents of Bangladesh, but subject to lower rates as provided in paragraph 3 of Article 11. For example, if a permanent establishment in Bangladesh is a branch of a U.S. financial institution, including an insurance company, the rate of tax on branch excess interest is limited to five percent, the rate applicable under paragraph 3 of Article 11 to interest beneficially owned by financial institutions.

**Article 15. Independent Personal Services**

Internal taxation rules

United States

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

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

Bangladesh

A nonresident individual engaged in a profession or a business in Bangladesh generally is subject to income tax at a flat rate of 25 percent and is not entitled to any deductions or other allowances.

Proposed treaty limitations on internal law

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

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

The Technical Explanation states that the term "fixed base" is understood to be similar, but not identical, to the term "permanent establishment," as defined in Article 5 of the proposed treaty. According to the Technical Explanation, the determination of whether a fixed base is regularly available to an individual is made on the basis of all relevant facts and circumstances. The Technical Explanation states that a fixed base in a treaty country generally will be considered readily available to an individual if it is at the disposal of the individual whenever that individual performs services in that country.

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

This article is subject to the saving clause of paragraph 2 of Article 1 (Personal Scope). Thus, if a U.S. citizen who is resident in Bangladesh performs independent personal services in the United States, the United States may tax the income attributable to such services without regard to the restrictions of this article, subject to the foreign tax credit described in Article 23 (Relief from Double Taxation).

**Article 16. Dependent Personal Services**

Under the proposed treaty, salaries, wages, and other remuneration derived from services performed as an employee in one treaty country (the source country) by a resident of the other treaty country are taxable in the country of residence, and generally such remuneration may also be taxed in the source country if the employment is exercised in the source country. However, such income is taxable only by the country of residence if three requirements are met: (1) the individual is present in the source country for not more than 183 days in any 12-month period commencing or ending in the taxable year or year of assessment concerned; (2) the individual is paid by, or on behalf of, an employer who is not a resident of the source country; and (3) the remuneration is not borne by a permanent establishment or fixed base of the employer in the source country. These limitations on source country taxation are similar to the rules of the U.S. model and OECD model. The Technical Explanation states that this article of the proposed treaty applies to any form of compensation for employment, including payments in kind, regardless of whether the remuneration is similar to salaries and wages.

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

The proposed treaty specifically provides that, notwithstanding the other provisions of this article and the separate article covering independent personal services (Article 15), if an individual who is a resident of one treaty country and receives director's fees as a director of a company that is resident in the other treaty country, and if the individual is also a shareholder of the company, the portion of the director's fee that exceeds what would have been paid had the individual not been a shareholder may be taxed by the first treaty country, but the rate of tax may not exceed 15 percent of that amount. Thus, the amount of the excess is subject to tax at the same 15-percent rate to which the proposed treaty generally limits source-country taxation of dividends (see Article 10).

This article is subject to the provisions of the separate articles covering entertainers and athletes (Article 18), pensions (Article 19), government service income (Article 20), and teachers, students and trainees (Article 21).

## Article 17. Limitation on Benefits

### In general

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

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

The proposed anti-treaty shopping article provides that a treaty country resident is entitled to all treaty benefits only if it is described in one of several specified categories. Generally, a resident of either country qualifies for the benefits accorded by the proposed treaty if the resident satisfies any other specified conditions for obtaining benefits and is, subject to the rules described in more detail below, (1) an individual; (2) a governmental entity; (3) an entity that satisfies an ownership test and a base erosion test; (4) a publicly-traded company; (5) a subsidiary of a publicly-traded company; or (6) a tax-exempt organization.

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

### Individuals

Under the proposed treaty, an individual resident of one of the treaty countries is entitled to all treaty benefits.

Governmental entities

Under the proposed treaty, the governments of the treaty countries and political subdivisions or local authorities are entitled to all treaty benefits.

Companies that satisfy ownership and base erosion tests

Under the proposed treaty, an entity that is a resident of one of the countries is entitled to treaty benefits if it satisfies an ownership test and a base erosion test. Under the ownership test, certain persons entitled to treaty benefits under one of the categories described above or below (an individual; a governmental entity; a publicly-traded company; a subsidiary of a publicly-traded company; or a tax-exempt organization), or citizens of the United States, must own (directly or indirectly) more than 50 percent of the beneficial interests in the entity or, in the case of a company, more than 50 percent of the number of shares of each class of the company's shares.

The base erosion test is satisfied only if no more than 50 percent of the person's gross income for the taxable period is used (directly or indirectly) to make deductible payments to persons who are not citizens of the United States and are not entitled to treaty benefits under other provisions of Article 17. The term "gross income" is not defined in the proposed treaty. In accordance with Article 3 (General Definitions) of the proposed treaty, the term will be defined under the domestic laws of the two countries. The Technical Explanation states that in determining whether a person deriving U.S.-source income is entitled to treaty benefits, the United States will define "gross income" as gross receipts less cost of goods sold. The Technical Explanation also states that deductible payments include interest and royalties; that trust distributions are deductible payments to the extent they are deductible from the taxable base; and that depreciation and amortization deductions are disregarded in applying the 50-percent test because they are not payments.

The Technical Explanation states that a trust may be entitled to the benefits of this provision if it is treated as a resident of one of the countries and otherwise satisfies the requirements of the provision.

Public companies

A company that is a resident of Bangladesh or the United States is entitled to treaty benefits if there is substantial and regular trading in its principal class of shares on a recognized stock exchange. The proposed treaty does not define "principal class of shares." The Technical Explanation states that, consistent with other recent U.S. treaties and the U.S. model, the United States will interpret this term as meaning the class of shares that represents the majority of the voting power and value of the company. In most cases, according to the Technical Explanation, this class will be the common or ordinary shares of the company. If no single class of shares accounts for more than half of a company's voting power and value, the Technical Explanation states that a group of two or more classes that satisfies the majority vote-and-value test must be identified, and each class of shares in the group must satisfy the regular trading requirement.

The term "recognized stock exchange" means the NASDAQ; any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934; the stock exchanges regulated by the Bangladesh Securities and Exchange Commission; and any other stock exchange agreed upon by the competent authorities of the two countries.

The proposed treaty is silent as to when shares are considered "regularly traded," and in accord with Article 3 (General Definitions), the term will be defined under the domestic laws of the two countries. The Technical Explanation states that for U.S. tax purposes the term is to have the meaning it has under Treas. Reg. sec. 1.884-5(d)(4)(i)(B).[18] Under this regulation, a class of shares is considered to be "regularly traded" if two requirements are met: (1) trades in the class of shares are made in more than de minimis quantities on at least 60 days during the taxable year, and (2) the aggregate number of shares in the class traded during the year is at least 10 percent of the average number of shares outstanding during the year.

<u>Subsidiaries of public companies</u>

A company that is a resident of Bangladesh or the United States is entitled to treaty benefits if at least 50 percent of each class of shares in the company is owned (directly or indirectly) by five or fewer companies that satisfy the public company test described immediately above, provided that in the case of indirect ownership each intermediate owner is entitled to treaty benefits under one of the six categories enumerated in paragraph 1 of Article 17 (an individual; a governmental entity; an entity that satisfies an ownership test and a base erosion test; a publicly-traded company; a subsidiary of a publicly-traded company; or a tax-exempt organization).

<u>Tax-exempt organizations</u>

Under the proposed treaty an entity is entitled to treaty benefits if it is organized under the laws of a treaty country; is generally exempt from tax in that treaty country; and is established and maintained in that country either (1) exclusively for religious, charitable, educational, scientific, or other similar purposes, or (2) to provide pensions or other similar benefits to employees pursuant to a plan, provided that more than 50 percent of the beneficiaries, members, or participants are persons that are entitled to treaty benefits under Article 17.

<u>Active business test</u>

Under the active business test, a resident of one of the countries is entitled to treaty benefits with respect to income derived from the other country if (1) the resident is engaged in the active conduct of a trade or business in its residence country, and (2) the income is derived in connection with, or is incidental to, that trade or business. If, however, the resident or any of its associated enterprises has an ownership interest in the income-producing activity in the other treaty country, the rule applies only if the trade or business in the residence country is substantial in relation to that income-producing activity. The proposed treaty provides that the business of

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

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, an insurance company, or a registered securities dealer.

Under the proposed treaty, income is considered to be derived "in connection with" an active trade or business if the activity in the other country generating the item of income is a line of business that forms a part of or is complementary to the trade or business. The Technical Explanation states that a business activity generally is considered to form a part of a business activity conducted in the other country if the two activities involve the design, manufacture, or sale of the same products or type of products or the provision of similar services. According to the Technical Explanation, the line of business in the residence country may be upstream, downstream, or parallel to the activity in the source country. An example of an upstream business is the provision of inputs for a manufacturing process in the source country. A downstream activity might be selling the output of that manufacturing process. A parallel activity might be selling the same kinds of products that are being sold by the source country trade or business. The Technical Explanation states that in order for two activities to be considered "complementary," the activities need not relate to the same types of products or services but that they should be part of the same overall industry and be related in the sense that the success or failure of one activity will tend to result in success or failure of the other.

The proposed treaty provides that income is "incidental to" a trade or business when it facilitates the conduct of the trade or business in the other country. The Technical Explanation gives as an example of incidental income the temporary investment of working capital derived from a trade or business.

The proposed treaty provides that whether a trade or business in the residence country is substantial in relation to the activity in the other treaty country is determined on the basis of all the facts and circumstances. The Technical Explanation states that this inquiry takes into account the relative scale of the activities conducted in each country and the relative contributions made to the conduct of the trades or businesses in the two countries. According to the Technical Explanation, the substantiality requirement is intended to prevent a narrow case of treaty shopping in which a company attempts to qualify for treaty benefits by engaging in de minimis business activities in its residence country. The substantiality requirement therefore applies only to related party cases because activities involving unrelated parties may not be abusive even if the residence country trade or business is very small in relation to the activities in the other country. As an example of the application of the substantiality rule, the Technical Explanation states that if a small U.S. research firm licenses a process to a large, unrelated Bangladesh drug manufacturer, the size of the U.S. firm would not need to be tested against the size of the Bangladesh manufacturer.

The term "trade or business" is not defined in the proposed treaty. Under Article 3 (General Definitions), undefined terms are to have the meaning that they have under the laws of the country applying the proposed treaty. 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 constitutes or could constitute an independent economic enterprise carried on for profit.

Grant of treaty benefits by the competent authority

The proposed treaty provides a "safety-valve" for a person that has not established that it satisfies one of the other more objective tests but for which the allowance of treaty benefits would not give rise to abuse or otherwise be contrary to the purposes of the treaty. Consequently, a resident of one of the countries who is not otherwise entitled to benefits under the proposed treaty may be granted benefits if the competent authority of the country in which the income in question arises so determines.

Consultation between competent authorities

The proposed treaty provides that the competent authorities may consult with one another to develop procedures for the common application of the limitation on benefits provisions. The proposed treaty also directs the competent authorities, in accordance with the provisions of Article 26 (Exchange of Information and Administrative Assistance) to exchange information necessary for carrying out the limitation on benefits rules.

## Article 18. Entertainers and Athletes

Like the U.S. and OECD models, the proposed treaty contains a separate set of rules that apply to the taxation of income earned by entertainers (such as theater, motion picture, radio, or television artistes or musicians) and athletes. The article applies both to the income of an entertainer or sportsman who performs services on his own behalf and one who performs services on behalf of another person, either as an employee of that person, or pursuant to any other arrangement. These rules are intended, in part, to prevent entertainers and athletes from using the treaty to avoid paying any tax on their income earned in one of the countries, and, accordingly, apply notwithstanding the inapplicability of the provisions dealing with the taxation of income from independent and dependent personal services (Articles 15 and 16). This article applies only with respect to the income of entertainers and athletes. Others involved in a performance or athletic event, such as producers, directors, technicians, managers, coaches, etc., remain subject to the provisions of Articles 15 and 16. In addition, except as provided in paragraph 2 of this Article, income earned by legal persons is not covered by this article.

Under paragraph 1 of Article 18 of the proposed treaty, income derived by an entertainer or athlete who is a resident of one country from his or her personal activities as such in the other country may be taxed in the other country if the amount of the gross receipts derived by him or her from such activities exceeds $10,000 or its equivalent in Bangladesh taka for the taxable year. The $10,000 threshold includes expenses that are reimbursed to the entertainer or athlete or borne on his or her behalf. Under this rule, if a Bangladesh entertainer maintains no fixed base in the United States and performs (as an independent contractor) in the United States for total compensation of $9,000 during a taxable year, the United States would not tax that income. If, however, that entertainer's total compensation were $11,000, the full amount would be subject to U.S. tax. On the other hand, if such an entertainer earned $9,000 during a taxable year in the United States through a fixed base regularly available to him in the United States, the United States could tax him under the provisions of Article 15 (Independent Personal Services). The U.S.-Sri Lanka income tax and U.S. model treaties provide thresholds of $6,000 and $20,000, respectively.

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

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

Consistent with Article 15 (Dependent Personal Services), Article 18 also applies regardless of the timing of actual payment for services. Thus, a bonus paid to a resident of a treaty country with respect to a performance in the other country occurring in a particular taxable year would be subject to Article 18 for that year even if it was paid after the close of the year.

The proposed treaty provides that the rules above do not apply to income derived from activities performed in a treaty country by entertainers or athletes who are residents of the other country if such activities are wholly or mainly supported by public funds of the other treaty country or a political subdivision or local authority thereof. In such a case the income is not taxable in the country in which the activities are performed. The support rule of the proposed treaty is stricter than a similar rule contained in the recently ratified income tax treaty between the United States and Sri Lanka, which provides that the income of an entertainer who is resident in a treaty country is not taxed in the (other) treaty country in which the activities are exercised if the visit is directly or indirectly supported wholly or substantially from the public funds of either treaty country (or political subdivision or local authority).[19]

Paragraph 2 of this article provides that where income in respect of activities performed by an entertainer or athlete in his or her capacity as such accrues not to the entertainer or athlete but to another person, that other person's income is taxable in the country in which the activities are performed unless it is established that neither the entertainer nor athlete, nor persons related to him or her, participate directly or indirectly in the profits of that other person in any manner, including the receipt of deferred remuneration, bonuses, fees, dividends, partnership distributions, or other distributions. This provision is intended to prevent highly-paid entertainers and athletes from avoiding tax in the country in which they perform by, for example,

[19] *See* Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty between the United States and the Democratic Socialist Republic of Sri Lanka* (JCS-2-04), February 19, 2004.

routing the compensation for their services through a personal holding company (a "star company") located in the residence country that does not have a permanent establishment in the source country. At the same time, the provision is intended to protect a performer's rights under the treaty when there is a legitimate employer-employee relationship between the performer and the person providing his services. If the star company is not a resident of the United States or Bangladesh, then the treaty (and this provision) does not apply. If the star company passes the residency threshold, however, this provision applies notwithstanding the articles governing business profits, income from independent personal services and income from dependent personal services (Articles 7, 15 and 16). The effect of this provision is that the star company may be taxed in the treaty country in which the performer's services are exercised. The income taxable by virtue of this paragraph is reduced to the extent of salary payments taxed to the performer.

This article is subject to the provisions of the saving clause of paragraph 2 of Article 1 (Personal Scope). Thus, if an entertainer or an athlete who is resident in Bangladesh is a citizen of the United States, the United States may tax all of his income from performances in the United States without regard to the provisions of this article, subject, however, to the special foreign tax credit provisions of paragraph 3 of Article 23 (Relief from Double Taxation). In addition, the benefits of this article are subject to the provisions of Article 17 (Limitation on Benefits).

**Article 19. Pensions, Et Cetera**

Paragraph 1 of Article 19 of the proposed treaty, like the U.S. model, generally provides that private pensions and other similar remuneration in consideration of past employment paid to a resident of one country may be taxed only in the recipient's country of residence. However, in the case of a citizen of one country who is a resident of the other country, the saving clause of Article 1, paragraph 2, of the proposed treaty provides that, notwithstanding this provision, a country may tax its residents and citizens as if the proposed treaty were not in effect. The Technical Explanation states as an example that a U.S. citizen who is a resident of Bangladesh and receives a pension payment from the United States may be subject to U.S. income tax on the payment.

The Technical Explanation states that, in the United States, the payments covered by the general rule of the provision include payments under qualified plans under Code section 401(a), individual retirement plans (including individual retirement plans that are part of a simplified employee pension plan that satisfies Code section 408(k), individual retirement accounts, individual retirement annuities, section 408(p) accounts, and Roth IRAs under section 408A), section 403(a) qualified annuity plans, and section 403(b) plans. Distributions from section 457(b) governmental plans may also fall under paragraph 1 if they are not paid with respect to government services covered by Article 20 (Government Service). The Technical Explanation further notes that the competent authorities may agree that payments under other plans that generally meet similar criteria also qualify for benefits under the provision.

Paragraph 1 of this article does not generally apply to pensions in respect of government service. Rather, such payments are covered either by paragraph 2 of this article if they are in the form of social security payments, or by paragraph 2 of Article 20, which provides generally that pensions paid from the public funds of one county in respect of government service may be taxed only in that country. If a pension in respect of government service is not covered by Article 20 solely because the service is rendered in connection with a business carried on by the government of a treaty country, however, the pension is covered by this article.

The treatment of pensions paid under a social security system is described in paragraph 2 of this article, and follows the U.S. model. Under paragraph 2, social security payments and other public pensions paid by one country to a resident of the other country or to a citizen of the United States may be taxed only in the source country. The provision applies to social security payments of either private or government employees. The reference to other public pensions is intended to refer to United States tier 1 Railroad Retirement benefits.

Paragraph 3 of this article provides that annuities derived by a resident of a treaty country are taxable only in that country. “Annuities” means a stated sum paid periodically at stated times during life or during a specified number of years, under an obligation to make the payments in return for adequate and full consideration, other than for services rendered.

Paragraphs 4 and 5 deal with alimony and child support payments, which are different types of periodic payments made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support. Alimony payments are those taxable to the recipient under the laws of the treaty country of his or her residence, and under paragraph 4 are not taxable by the other treaty country. Child support payments are payments for the support of a minor child that are exempt from tax under the laws of the country in which the recipient is resident, and, under paragraph 5, are exempt from tax in both treaty countries.

The saving clause of Article 1 applies to private pension, annuity, and alimony payments. Thus, a U.S. citizen who is a resident of Bangladesh and receives a private pension, annuity, or alimony payment may be subject to U.S. tax on such payment. The saving clause does not apply with respect to the provisions relating to social security and child support payments. Thus, as noted in the Technical Explanation, a U.S. citizen is not subject to U.S. tax on Bangladesh social security payments.

**Article 20. Government Service**

Under paragraph 1 of Article 20 of the proposed treaty, remuneration, other than a pension, paid by a treaty country (or a political subdivision or local authority thereof) to any individual for services rendered to that country (or subdivision or authority) is taxable only in that country. However, the services are taxable only in the other country if the services are rendered there and the individual is a resident of that other country who is either a national of that other country or who did not become a resident of that other country solely for the purpose of rendering the services. According to the Technical Explanation, the provision applies both to government employees and to independent contractors engaged by governments to perform services for them.

Paragraph 2 covers pensions that are not in the form of social security benefits and are in respect of government service rendered to a treaty county (or subdivision or authority) by an individual. Such pensions are taxable only in that country. However, such pensions are taxable only in the other country if the individual is both a resident and a national of the other country.

Pensions paid to retired civilian and military employees of the Government of either country are intended to be covered under paragraph 2.

When benefits paid by a treaty country in respect of services rendered to that country (or subdivision or authority) are in the form of social security benefits, however, those payments are covered by paragraph 2 of Article 19 (Pensions, Et Cetera). As a general matter, the result will be the same whether Article 19 or 20 applies, since both social security benefits and government pensions are taxable exclusively by the source country. According to the Technical Explanation, the result differs only when the payment is made to a citizen and resident of the other country, who is not also a citizen of the paying country. In such a case, social security benefits continue to be taxable at source while government pensions are taxable only in the residence country.

The treatment of payments described in paragraphs 1 and 2 of this article are subject to the provisions of those paragraphs and not to those of Articles 15 (Independent Personal Services), 16 (Dependent Personal Services), 18 (Entertainers and Athletes) or, except as noted above for social security payments, 19 (Pensions, Et Cetera). If, however, the remuneration or pension is paid for services performed in connection with a business carried on by a treaty country (or subdivision or authority), those other articles, and not this article, apply.

The provisions of this article are exceptions to the proposed treaty's saving clause (Article 1, paragraphs 2 and 3(b)) for individuals who are neither citizens nor persons admitted for permanent residence (in the United States, a "green card" holder) of the country where the benefits are conferred. Thus, for example, a salary paid by the government of Bangladesh to an employee resident in the United States who holds a green card is taxable in Bangladesh under paragraph 1 of this article and is taxable in the United States under the saving clause, subject to the provisions of Article 23 (Relief From Double Taxation). However, such employee would be taxable solely in the United States if the employee did not become a resident of the United States solely to render the services.

## **Article 21. Teachers, Students and Trainees**

Under the proposed treaty, a professor or teacher who visits a country (the host country) for the purpose of teaching or engaging in research at a university, college, or other recognized educational institution of a similar nature, and who immediately before that visit is, or was a resident of the other treaty country, generally is exempt from host country tax on any remuneration received for teaching or research. This exemption applies for not more than the two-year period beginning on the date of the professor's or teacher's arrival in the host country. Such a provision is not part of the U.S. model. Such a provision is not part of the OECD model.

The treatment provided to students and business trainees under the proposed treaty generally corresponds to the provision in the U.S. model, with certain modifications, and is similar to the provision of the OECD model. Under the proposed treaty, a student or business trainee who visits a country (the host country) for the primary purpose of his or her full-time education, or for his or her full-time training, and who immediately before that visit is or was a resident of the other treaty country, generally is exempt from host country tax on payments he or she receives for the purpose of such maintenance, education, or training; provided, however, that such payments arise outside the host country. The proposed treaty also would provide that an individual who visits a country (the host country) for the primary purpose of studying or doing research as a recipient of a grant, allowance or award from a governmental, religious, charitable, or educational organization, and who immediately before that visit is, or was a resident of the other treaty country, is exempt from income tax in the host country with respect to the grant, allowance, or award. The provision only applies in the case of research undertaken in the public interest. Such a student, business trainee, or grant recipient also is exempt from host country tax on any remuneration for personal services rendered in the host country in an amount not exceeding $8,000 (or the equivalent in Bangladesh taka). In the case of a business trainee, this exemption is limited to the two-year period commencing on the date of the individual's first arrival in the host country. There is no time-period limitation in the case of students or research grant recipients. The Technical Explanation clarifies that all such exemptions provided under Article 21 of the proposed treaty are in addition to other exemptions provided by the U.S. Internal Revenue Code.

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

**Article 22. Other Income**

This article is a catch-all provision intended to cover items of income not specifically covered in other articles, and to assign to either the United States or Bangladesh the right to tax income from third countries. As a general rule, items of income not otherwise dealt with in the proposed treaty which are beneficially owned by a resident of one of the treaty countries are taxable only in the country of residence.

The general rule described above is modified in two ways. First, income, other than income from real property, which is received by a resident of a treaty country and which is effectively connected with a permanent establishment or a fixed base maintained in the other treaty country may be taxed by that other country under the rules of Article 7 (Business Profits) and Article 15 (Independent Personal Services). This rule is consistent with the rule in the U.S. model. The Technical Explanation states that the rule applies even if the income is sourced in a third country. The carve-out of income from real property means that, consistent with the rules of Article 6 (Income from Immovable Property), income from real property located in the residence country or in a third country is taxable only in the residence country (and not the source country) even if the income is attributable to a permanent establishment or a fixed base in the source country.

Second, the general rule described previously is modified to allow the source country a nonexclusive right to tax "other income" arising within the source country. As a result, both the residence country and the source country may tax this income, leaving the resulting double taxation to be resolved under Article 23 (Relief from Double Taxation). This provision is a departure from the U.S. model but is consistent with the U.N. model and with other treaties that the United States has concluded with developing countries. As an illustration of the kind of income to which this provision might apply, the Technical Explanation states that Bangladesh-source gambling income of a U.S. resident may be taxed by both the United States and Bangladesh.

The Technical Explanation offers as additional examples of "other income" punitive damages, payments for a covenant not to compete, and income from certain financial instruments. The Technical Explanation also notes that the article applies to items of income that are not dealt with because of their source. For example, interest arising in a third country that is not attributable to a permanent establishment in the United States or Bangladesh is subject to Article 22.

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

This article is subject to the saving clause; U.S. citizens who are residents of Bangladesh will be taxable by the United States on income that is not dealt with elsewhere in the proposed treaty. The benefits of this article are also subject to the provisions of Article 17 (Limitation on Benefits).

## Article 23. Relief From Double Taxation

Internal taxation rules

United States

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

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

Bangladesh

Like the United States, Bangladesh generally provides unilateral double tax relief by allowing a foreign tax credit. The foreign tax credit cannot exceed the amount of Bangladesh tax imposed on the foreign-source income.

Proposed treaty limitations on internal law

Overview

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

Part of the double tax problem is dealt with in other articles of the proposed treaty that limit the right of a source country to tax income. This article provides further relief where both Bangladesh and the United States otherwise still tax the same item of income. This article is not subject to the saving clause; therefore the country of citizenship or residence will waive its overriding taxing jurisdiction to the extent that this article applies. For example, as more fully discussed below, Bangladesh is required to provide a foreign tax credit for U.S. taxes paid or deemed paid by its citizens and residents.

Proposed treaty restrictions on internal law

The proposed treaty generally provides that the United States will allow a U.S. citizen or resident a foreign tax credit for the income taxes paid or accrued to Bangladesh. The proposed treaty also requires the United States to allow a deemed-paid credit with respect to Bangladesh income tax, consistent with Code section 902, to any U.S. company that receives dividends from a Bangladesh company if the U.S. company owns ten percent or more of the voting stock of the Bangladesh company. The credit generally is to be computed in accordance with the provisions and subject to the limitations of U.S. law in effect at the time a credit is given (as such law may be amended from time to time without changing the general principle of the credit). For example, U.S. statutory law governs the foreign tax credit limitations imposed under Code section 904, the relevant currency translation rules, and the carryover periods for excess credits. This provision is similar to those found in the U.S. model and other U.S. income tax treaties. The proposed treaty provides that the taxes referred to in paragraphs 2(b) and 3 of Article 2 (Taxes Covered) will be considered creditable income taxes for purposes of the U.S. foreign tax credit.

The proposed treaty generally provides that Bangladesh will allow its residents a foreign tax credit for the income taxes paid or accrued to the United States. The proposed treaty also requires Bangladesh to allow a deemed-paid credit with respect to Bangladesh income tax to any Bangladesh company that receives dividends from a U.S. company if the Bangladesh company owns ten percent or more of the voting stock of the U.S. company. The credit generally is to be computed in accordance with the provisions and subject to the limitations of Bangladesh law in effect at the time a credit is given (as such law may be amended from time to time without changing the general principle of the credit). This provision is similar to those found in the U.S. model and other U.S. income tax treaties. The proposed treaty provides that the taxes referred to in paragraphs 2(a) and 3 of Article 2 (Taxes Covered) will be considered creditable income taxes for purposes of the Bangladesh foreign tax credit.

The proposed treaty contains special rules for the tax treatment of certain U.S.-source income derived by a U.S. citizen who is a resident of Bangladesh. With respect to an item of income that would have been exempt from U.S. tax or subject to U.S. tax at a reduced rate if earned by a Bangladesh resident who was not a U.S. citizen, Bangladesh is required to allow a foreign tax credit only up to the amount of U.S. tax that the United States is allowed to impose under the proposed treaty, not including U.S. taxes that may be imposed solely by reason of citizenship under the treaty's saving clause. In these cases, the United States is required to credit the income taxes paid or accrued to Bangladesh (after the application of the rule described in the preceding sentence) in determining the amount of U.S. tax owed with respect to this income. To the extent necessary to avoid double taxation, this otherwise U.S.-source income will be treated as Bangladesh-source in applying the U.S. foreign tax credit limitation.

## Article 24. Nondiscrimination

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

In general, under the proposed treaty, one country cannot discriminate by imposing more burdensome taxes on nationals of the other country than it would impose on its own comparably situated nationals in the same circumstances.[20] Not all instances of differential treatment are discriminatory. Differential treatment is permissible in some instances under this rule on the basis of tax-relevant differences (e.g., the fact that one person is subject to worldwide taxation in a contracting state and another person is not, or the fact that an item of income may be taxed at a later date in one person's hands but not in another person's hands).

Under the proposed treaty, neither country may tax a permanent establishment of an enterprise of the other country less favorably than it taxes its own enterprises carrying on the same activities.

Similar to the U.S. and OECD models, however, a country is not obligated to grant residents of the other country any personal allowances, reliefs, or reductions for tax purposes that are granted to its own residents or nationals.

Subject to the anti-avoidance rules described in paragraph 1 of Article 9 (Associated Enterprises), paragraph 5 of Article 11 (Interest), and paragraph 5 of Article 12 (Royalties), each treaty country is required to allow its residents to deduct interest, royalties, and other disbursements paid by them to residents of the other country under the same conditions that it allows deductions for such amounts paid to residents of the same country as the payor. The

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

Technical Explanation states that the term "other disbursements" is understood to include a reasonable allocation of executive and general administrative expenses, research and development expenses, and other expenses incurred for the benefit of a group of related persons that includes the person incurring the expense. The Technical Explanation further states that the exception with respect to paragraph 5 of Article 11 (Interest) would include the denial or deferral of certain interest deductions under section 163(j) of the Code, thus preserving for the United States the ability to apply its earnings stripping rules. The proposed treaty also provides that this provision does not affect the application of the law of Bangladesh requiring that tax be deducted at source from payments of interest, royalties, and other disbursements, as a condition for deduction against income. In addition, any debts of a resident of one treaty country to a resident of the other treaty country are, for purposes of determining the taxable capital of the obligor, deductible under the same conditions as if they had been owed to a resident of the same treaty country.

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

The proposed treaty provides that nothing in the nondiscrimination article may be construed as preventing either of the countries from imposing branch taxes as described in Article 14 (Branch Tax).

In addition, notwithstanding the definition of taxes covered in Article 2 (Taxes Covered), this article applies to taxes imposed by a treaty country or a political subdivision or local authority. The Technical Explanation states that customs duties are not regarded as taxes for this purpose.

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

## **Article 25. Mutual Agreement Procedure**

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

Under this article, a person who considers that the actions of one or both of the countries cause him or her to be subject to tax which is not in accordance with the provisions of the proposed treaty may (irrespective of internal law remedies) present his or her case to either competent authority. The Technical Explanation states that allowing a person to bring a case to either competent authority follows both the U.S. and OECD models. Under this approach, for example, a U.S. permanent establishment of a corporate resident in Bangladesh that faces inconsistent treatment in the two countries would be able to bring its complaint to the competent authority in either country.

The proposed treaty provides that if the objection appears to be justified and that competent authority is not itself able to arrive at a satisfactory solution, that competent authority must endeavor to resolve the case by mutual agreement with the competent authority of the other country, with a view to the avoidance of taxation which is not in accordance with the proposed treaty. The proposed treaty provides that any agreement reached will be implemented notwithstanding any time limits or other procedural limitations under the domestic laws of either country (e.g., a country's applicable statute of limitations).

The competent authorities of the countries are to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the proposed treaty. In particular, the competent authorities may agree to: (1) the same attribution of income, deductions, credits, or allowances of an enterprise of one treaty country to the enterprise's permanent establishment situated in the other country; (2) the same allocation of income, deductions, credits, or allowances between persons; (3) the same characterization of particular items of income; (4) the same application of source rules with respect to particular items of income; and (5) a common meaning of a term. The Technical Explanation clarifies that this is a non-exhaustive list of examples of the kinds of matters about which the competent authorities may reach agreement.

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

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

The proposed treaty also authorizes the competent authorities to increase dollar amounts[21] referred to in the proposed treaty. The Technical Explanation states that this authority allows the competent authorities to make changes to reflect economic or monetary developments. The Technical Explanation states this provision can be applied only to the benefit of taxpayers, i.e., only to increase dollar thresholds, not to reduce them.

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[21] The Technical Explanation states that this refers to specific dollar amounts referred to in the proposed treaty, such as the $10,000 exemption for entertainers and athletes (Article 18) and the $8,000 exemption for students and trainees (Article 21).

This article is not subject to the saving clause (Article 1) by virtue of the exceptions in that article. Thus, rules, definitions, procedures, etc. that are agreed upon by the competent authorities under this article may be applied by the United States with respect to its citizens and residents even if they differ from the comparable Code provisions.

The Technical Explanation provides that the provisions of Article 25 (Mutual Agreement Procedure) of the proposed treaty will have effect from the date of entry into force of the proposed treaty, without regard to the taxable or chargeable period to which the matter relates.

**Article 26. Exchange of Information and Administrative Assistance**

The proposed treaty provides that the two competent authorities will exchange such information as is necessary[22] to carry out the provisions of the proposed treaty, or the domestic laws of the two countries concerning all taxes covered by the treaty[23] insofar as the taxation thereunder is not contrary to the proposed treaty. Unlike the U.S. model, the exchange of information under this article is limited to taxes that are identified in Article 2 (Taxes Covered). The Technical Explanation states that Bangladesh was unable to provide authority to exchange information with respect to all national level taxes, as in the U.S. and OECD models.

This exchange of information is not restricted by Article 1 (General Scope). Therefore, information with respect to third-country residents is covered by these procedures. The Technical Explanation provides an example of a third-country resident with a permanent establishment in Bangladesh which engages in transactions with a U.S. enterprise. Under the proposed treaty, the United States could request information with respect to that permanent establishment, even though it is not a resident of either of the two countries.

Under the proposed treaty, the two competent authorities may exchange information on a routine basis, on request in relation to a specific case, or spontaneously. The Technical Explanation states that it is contemplated that all of these types of exchange will be utilized, as appropriate.

Any information exchanged under the proposed treaty is treated as secret in the same manner as information obtained under the domestic laws of the country receiving the information. The exchanged information may be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes to which the proposed treaty applies, or persons or authorities engaged in the oversight of such taxes (e.g., the tax-writing committees of Congress and the General

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

[23] Under Article 2 (Taxes Covered), the treaty applies to Federal income taxes imposed by the Code in the United States and the income tax (including surcharges calculated by reference to income tax) in Bangladesh.

Accounting Office). Such persons or authorities must use the information for such purposes only. Information received by these bodies must be for use in the performance of their role in overseeing the administration of U.S. tax laws. Exchanged information may be disclosed in public court proceedings or in judicial decisions.

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

If information is requested by a country in accordance with this article, the proposed treaty provides that the other country will obtain the requested information in the same manner and to the same extent as if the tax of the requesting country were the tax of the other country and were being imposed by that country, notwithstanding that such other country may not need such information at that time. Under the proposed treaty, the powers of each country's competent authority to obtain information include the ability to obtain information held by financial institutions, nominees, or persons acting in an agency or fiduciary capacity. This does not include the ability to obtain information that would reveal confidential communications between a client and an attorney, where the client seeks legal advice. The Technical Explanation also provides that the competent authorities may obtain information relating to the ownership of legal persons, such as the identity of a beneficial owner of bearer shares.

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

The Technical Explanation states that the provisions of Article 26 (Exchange of Information and Administrative Assistance) of the proposed treaty will have effect from the date of entry into force of the proposed treaty, without regard to the taxable or chargeable period to which the matter relates. Thus, once the proposed treaty is in force, the competent authority may seek information under the treaty with respect to a year prior to the entry into force of the treaty.

## Article 27. Effect of Convention on Diplomatic Agents and Consular Officers, Domestic Laws, and Other Treaties

### Diplomatic agents

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

Domestic laws and other treaties

The proposed treaty provides that it does not restrict in any manner any benefit accorded by internal law or by any other agreement between the United States and Bangladesh. Thus, the proposed treaty will not apply to increase the tax burden of a resident of either the United States or the Bangladesh. According to the Technical Explanation, the fact that the proposed treaty only applies to a taxpayer's benefit does not mean that a taxpayer may select inconsistently among treaty and internal law provisions in order to minimize its overall tax burden. In this regard, the Technical Explanation sets forth the following example. Assume a resident of Bangladesh has three separate businesses in the United States. One business is profitable and constitutes a U.S. permanent establishment. The other two businesses generate effectively connected income as determined under the Code, but do not constitute permanent establishments as determined under the proposed treaty; one business is profitable and the other business generates a net loss. Under the Code, all three businesses would be subject to U.S. income tax, in which case the losses from the unprofitable business could offset the taxable income from the other businesses. On the other hand, only the income of the business which gives rise to a permanent establishment is taxable by the United States under the proposed treaty. The Technical Explanation makes clear that the taxpayer may not invoke the proposed treaty to exclude the profits of the profitable business that does not constitute a permanent establishment and invoke U.S. internal law to claim the loss of the unprofitable business that does not constitute a permanent establishment to offset the taxable income of the permanent establishment.[24] If, however, the taxpayer invokes the Code for the taxation of all three ventures, he would not be precluded from invoking the proposed treaty with respect, for example, to any dividend income he may receive from the United States that is not effectively connected with any of his business activities in the United States.

The proposed treaty provides that the dispute resolution procedures under its mutual agreement procedure article (Article 25) (and not the corresponding provisions of any other agreement to which the United States and Bangladesh are parties) exclusively apply in determining whether a measure is within the scope of the proposed treaty. Unless the competent authorities agree that a taxation measure is outside the scope of the proposed treaty, only the proposed treaty's nondiscrimination rules, and not the nondiscrimination rules of any other agreement in effect between the United States and Bangladesh, generally apply to that law or other measure. The only exception to this general rule is such national treatment or most favored nation obligations as may apply to trade in goods under the General Agreement on Tariffs and Trade. For purposes of this provision, the term "measure" means a law, regulation, rule, procedure, decision, administrative action, or any other similar provision or action.

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

## Article 28. Entry into Force

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

With respect to taxes withheld at source, the individual provisions of the proposed treaty will be effective for amounts paid or credited on or after the first day of the second month following the date on which the proposed treaty enters into force. With respect to other taxes, the provisions of the proposed treaty will be effective for taxable periods in the United States and income years in Bangladesh beginning on or after January 1 of the year following entry into force.

The Technical Explanation states that, as described in the explanations of Article 25 (Mutual Agreement Procedure) and Article 26 (Exchange of Information and Administrative Assistance), the powers given to competent authority under those articles apply retroactively to taxable years preceding entry into force.

## Article 29. Termination

The proposed treaty will remain in force until terminated by either country. Either country may terminate the proposed treaty at any time after five years from the date of the treaty's entry into force, provided the country has given at least six months prior written notice of termination to the other country through diplomatic channels. In that case, a termination is effective with respect to taxes withheld at source for amounts paid or credited on or after January 1 next following the expiration of the six-month period following delivery of notice of termination. With respect to other taxes, a termination is effective for taxable periods in the United States and income years in Bangladesh beginning on or after January 1 next following the expiration of the six-month period.

The Technical Explanation states that if the proposed treaty is terminated, the competent authorities of the treaty countries are not permitted on or after termination to exchange confidential taxpayer information, regardless of whether the treaty was in force for the year to which the information relates. Similarly, on or after termination the competent authorities are not permitted to reach mutual agreement departing from internal law, regardless of the taxable year to which the agreement relates.

The Technical Explanation notes that customary international law as reflected in the Vienna Convention on Treaties permits termination by one treaty country at any time in the event of a "material breach" by the other treaty country.

## Exchange of Notes

At the signing of the proposed treaty, notes were exchanged dealing with two issues. First, the notes state that if the United States reaches agreement on the provision of a tax-sparing credit with any other country, the United States will reopen negotiations with Bangladesh with a view to the conclusion of a protocol extending a tax-sparing credit under the proposed treaty. This protocol would be subject to the usual ratification procedures of both countries.

This understanding between Bangladesh and the United States reflects the desire of Bangladesh and other developing countries that the United States adopt a tax-sparing credit. Many developed countries provide tax-sparing credits as a way of preventing developing countries' tax incentives for foreign direct investment from being offset by increased taxation of the investment by the developed countries (in the form of reduced foreign tax credits). A tax-sparing credit is an income tax credit provided by a country (typically a developed country) against its own tax on income from a developing country. The credit generally equals the full amount of the developing country's nominal tax on the income, notwithstanding the developing country's reduction or elimination of the tax as part of an investment incentive program. Many developing countries, for example, provide "tax holidays" to residents of other countries who invest in the developing country. Under these tax holidays developing countries typically forgo tax on the profits from the foreign-owned business for a period of time. Absent a tax-sparing credit, those profits typically would be taxed in full by the country of residence of the business' foreign owner upon repatriation in dividend form. The United States has declined to give tax-sparing credits.

The diplomatic notes also provide that if the tax authorities of the treaty countries do not have information sufficient to determine the profits to be attributed under Article 7 (Business Profits) to a permanent establishment, the determination may be made on a reasonable basis using principles consistent with Article 7.

# V. ISSUES

## A. Developing-Country Concessions

**In general**

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

**Definition of permanent establishment**

In several ways, the proposed treaty permits broader source-basis taxation than does the U.S. model. An example of this broadened source taxation is the proposed treaty's permanent establishment article. This article permits the country in which business activities are performed to tax the income from these activities in a broader range of circumstances than would be permitted under the U.S. model. The most important differences between the permanent establishment articles in the proposed treaty and the U.S. model are described below.

Under the proposed treaty, a building site, a construction or installation project, or an installation or drilling rig used for the exploration or development of natural resources constitutes a permanent establishment if the site, project, or installation or rig lasts more than 183 days. The U.S. model's threshold, by contrast, is 12 months.

The proposed treaty expands the circumstances in which a dependent agent's activities give rise to permanent establishment status. Under the U.S. model, a dependent agent's activities in a treaty country create a permanent establishment in that country for the enterprise on behalf of which the agent is acting only if the agent has and habitually exercises in that country authority to conclude binding contracts for the enterprise. The proposed treaty includes this general rule but also provides that if a dependent agent has no authority to conclude contracts, the agent's activities nonetheless create a permanent establishment in a treaty country if the agent habitually maintains in that country a stock of goods or merchandise belonging to the enterprise from which the agent regularly fills orders or makes deliveries on behalf of the enterprise, and additional activities conducted in that country on behalf of the enterprise contribute to the conclusion of the sale of the goods or merchandise.

The proposed treaty's conception of a permanent establishment is broader than the U.S. model's conception in two additional respects. First, under the proposed treaty, the maintenance of a fixed place of business solely for any combination of certain activities involving the storage, display, purchase, or maintenance of goods or merchandise does not give rise to a permanent establishment if the overall character of the fixed place of business is of a preparatory or an auxiliary character. The U.S. model does not include this preparatory or auxiliary character requirement for the exclusion from permanent establishment status. Second, the proposed treaty excludes from permanent establishment status the use of facilities or the maintenance of a stock of goods for the purpose of occasional delivery of the goods or merchandise. The U.S. model's exclusion applies regardless of whether delivery is only occasional.

**Other concessions to source-basis taxation**

In several instances, the proposed treaty allows higher rates of source-country tax than the U.S. model allows. Like the U.S. model, the proposed treaty allows a maximum rate of source-country taxation of 15 percent on dividends. When, however, the beneficial owner of a dividend is a company that owns at least 10 percent of the dividend paying company's voting stock, the maximum source-country tax rates under the proposed treaty and the U.S. model differ. The proposed treaty's maximum source-country rate in this circumstance is 10 percent, while the U.S. model's maximum rate is 5 percent. The proposed treaty's 10-percent rate in this circumstance is, however, lower than the 15-percent maximum rate permitted in the U.S.-Sri Lanka income tax treaty (as amended by a protocol signed in 2002). The proposed treaty also allows source-country taxation of interest and royalties at a maximum rate of 10 percent, whereas the U.S. model generally does not permit source-country taxation of interest or royalties. The proposed treaty also allows the source country a non-exclusive right to tax "other income" (that is, income not specifically dealt with in other provisions of the treaty), whereas the U.S. model provides for exclusive residence-based taxation of that income.

The proposed treaty permits source-country taxation of income derived by an individual resident of the other treaty country from the performance of independent personal services in the source country if the individual is present in that country for a total of more than 183 days during any 12-month period, even if the income is not attributable to a fixed base or permanent establishment. The U.S. model requires as a condition of source-country taxation that the income be attributable to a fixed base or permanent establishment in the source country.

The proposed treaty also includes a lower dollar threshold than the U.S. model's threshold for source-country taxation of income of entertainers and athletes. Under the proposed treaty, the source country may tax the income from activities performed in that country by entertainers and athletes if the income exceeds $10,000 (or the equivalent amount in Bangladesh taka) in a year. The U.S. model's threshold is $20,000. By comparison, the threshold in the U.S.-Sri Lanka income tax treaty is $6,000.

**Issues**

One purpose of the proposed treaty is to reduce tax barriers to direct investment by U.S. firms in Bangladesh. The practical effect of the developing-country concessions in the proposed treaty could be greater Bangladesh taxation (or less U.S. taxation) of activities of U.S. firms in Bangladesh than would be the case under rules comparable to those of the U.S. model.

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

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

## B. Expatriation to Avoid Tax by Former U.S. Citizens and Long-Term Residents

There is a potential conflict between the special expatriation tax regime of U.S. internal law and the proposed treaty. The saving clause that the proposed treaty would adopt uses the obsolete "principal purposes of tax avoidance" formulation in determining whether the special tax regime may apply to individuals who expatriate, even though the subjective determinations of tax-avoidance purpose under prior law were recently eliminated and replaced with objective rules for determining the applicability of the special tax regime.[25]

The saving clause of the proposed treaty applies to former U.S. citizens and long-term residents whose loss of citizenship or termination of residency status had as one of its principal purposes the avoidance of U.S. income tax. The provision is limited to the 10-year period following the loss of U.S. citizenship.

Before section 877 was amended by AJCA, individuals who met a specified income tax liability threshold or a specified net worth threshold generally were considered to have lost citizenship or resident status for a principal purpose of U.S. tax avoidance, but the law allowed for subjective determinations of tax-avoidance purpose. Certain categories of individuals, including a very limited class of dual residents or citizens, could avoid being deemed to have a tax avoidance purpose for relinquishing citizenship or terminating residency by submitting a ruling request to the IRS for a determination as to whether the relinquishment of citizenship or termination of residency had as one of its principal purposes the avoidance of U.S. income, estate or gift taxes.

Under the regime prior to its amendment by AJCA, if a former U.S. citizen or long-term resident relinquished U.S. citizenship or terminated U.S. residency with a principal purpose of avoiding U.S. taxes, the individual was subject to a special set of income, estate, and gift tax rules for the 10-year period following such loss of status. Under present and prior law, these rules mainly have the effect of expanding the scope of income and wealth transfers that are subject to taxation by the United States, such that the individual is subject to U.S. tax on a somewhat broader basis than other nonresident aliens, but still on a narrower basis than a current U.S. citizen or resident. Under prior law, for purposes of determining the applicability of the regime, an individual who relinquished citizenship or terminated residency was treated as having done so with a principal purpose of tax avoidance if the individual's average Federal income tax liability or net worth exceeded certain monetary thresholds, but certain categories of individuals (e.g., dual residents) could avoid this presumption by requesting a ruling from the IRS that they did not have such a principal purpose, based on the relevant facts and circumstances.

AJCA eliminated these subjective determinations of tax-avoidance purpose and replaced them with objective rules. Under the regime as amended by AJCA, a former citizen or former

[25] Substantial changes to the special expatriation rules were included in AJCA, which was signed into law on October 22, 2004 (roughly one month after the proposed treaty was signed, on September 26, 2004). The proposed treaty thus does not reflect these recent changes.

long-term resident is subject to the special income, estate, and gift tax rules for expatriates unless the individual: (1) establishes that his or her average annual net income tax liability for the five preceding years does not exceed $124,000 (adjusted for inflation after 2004) and his or her net worth is less than $2 million, or alternatively satisfies limited, objective exceptions for dual citizens and minors who have had no substantial contact with the United States; and (2) certifies under penalties of perjury that he or she has complied with all Federal tax obligations for the preceding five years and provides such evidence of compliance as the Treasury Secretary may require. Thus, as a result of AJCA, the application of the expatriation tax regime no longer turns on determinations of whether a person had a principal purpose of tax avoidance, as it often did prior to AJCA.

The Technical Explanation notes that under the proposed treaty, the determination of whether there was a principal purpose of tax avoidance with respect to former citizens or long-term residents of the United States is made under the laws of the United States. The Technical Explanation further states that the new objective tests "represent the administrative means by which the United States determines whether a taxpayer has a tax avoidance purpose." Thus, although the proposed treaty employs the now-obsolete concept of a tax-avoidance purpose, the Technical Explanation maintains that this language should be understood as fully preserving U.S. taxing jurisdiction under the expatriation tax rules in their current form.

The Committee may wish to satisfy itself that the language included in the proposed treaty allows the United States to exercise its full taxing jurisdiction with respect to former citizens and long-term residents. The Committee also may wish to inquire as to why the language of the proposed treaty was not updated to eliminate potential conflicts with section 877, as revised by AJCA.

## C. Education and Training

**Treatment under proposed treaty**

Under Article 21 of the proposed treaty, U.S. taxpayers who are visiting Bangladesh and individuals who immediately prior to visiting the United States were resident in Bangladesh will be exempt from income tax in the host country on certain payments received if the purpose of their visit is to teach or engage in research at university, college or other educational institution, to engage in full-time education, to engage in full-time training, or to undertake public interest research as a grant recipient. In the case of individuals engaged in teaching or research at a college, university, or other educational institution, the exemption covers any remuneration for such teaching or research. In the case of individuals other than teachers, the exempt payments are limited to those payments the individual may receive for his or her maintenance, education or training as long as such payments are from sources outside the host country, the amount of grant or award, and up to $8,000 (or the equivalent in Bangladesh taka) in personal services income. In the case of an individual engaged in teaching or research at a university, college, or other educational institution, and in the case of a business trainee, the exemption from income tax in the host country applies for a period of two years.

**Issues**

Full-time students and persons engaged in full-time training.–The proposed treaty generally has the effect of exempting payments received for the maintenance, education, and training of full-time students and persons engaged in full-time training as a visitor from the United States to Bangladesh or as a visitor from Bangladesh to the United States from the income tax of both the United States and Bangladesh. This conforms to the U.S. model with respect to students and generally conforms to the OECD model provisions with respect to students and trainees. In addition, under the proposed treaty such individuals may earn up to $8,000 per year in personal services income free of tax. The allowance of an exemption for personal service income earned in the host country departs from both the U.S. and OECD models.

The proposed treaty applies a more stringent standard when the visiting individual is an employee of a person in his or her home country undertaking training in the host country. For such an individual the exemption for payments received for the maintenance, education, and training and up to $8,000 in personal service income is limited to two years. In this regard the proposed treaty departs from both the U.S. model and the OECD model. The U.S. model limits exemptions for payments of maintenance, education, and training for one year in the case of business trainees but does not provide any exemption related to personal services income. The OECD model does not limit the duration of exemption for payments for maintenance, education, and training for business trainees and does not provide any exemption related to personal services income.

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

It could be argued that the training or education of an employee relates primarily to specific job skills of value to the individual or the individual's employer rather than enhancing general knowledge and cross-border understanding, as may be the case in the education or training of a non-employee visitor. This could provide a rationale for providing more open-ended treaty benefits in the case of non-employee students and trainees as opposed to employees. However, if employment provides the underlying rationale for disparate treaty benefits, a question might arise as to why training requiring two years or less is preferred to training that requires a longer visit to the host country. As such, the proposed treaty would favor certain types of training arrangements over others. On the other hand, there may be few training programs that exceed two years duration.

Teachers and professors.–The proposed treaty is inconsistent with the U.S. model in which no such exemption would be provided for the remuneration of visiting teachers, professors, or academic researchers. While the position of the U.S. model is to provide no such exemption, 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, 31 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 11 treaties provide a more limited exemption from taxation in the host county for a visiting individual engaged in research. Four of the most recently ratified income tax treaties did contain such a provision.[26]

Under the Code, a U.S. person earning income abroad may exempt from U.S. tax up to $80,000 of foreign earned income.[27] Thus, in the case of a U.S. person temporarily locating in Bangladesh to teach, the proposed treaty would provide the U.S. person with up to $80,000 in tax-free income. The effect of such exemptions for the remuneration of visiting teachers, professors, and academic researchers generally is to make such cross-border visits more attractive financially. Increasing the financial reward may serve to encourage cross-border visits by academics. Such cross-border visits by academics for teaching and research may foster the advancement of knowledge and redound to the benefit of residents of both countries. On the other hand, such an exemption from income tax may be seen as unfair when compared to persons engaged in other occupations whose occupation or employment may cause them to relocate temporarily abroad. Such exemptions for remuneration of teachers, professors, and academic researchers could be said to violate the principle of horizontal equity by treating otherwise similarly economically situated taxpayers differently.

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[26] The treaties with Slovenia and Venezuela, both considered in 1999, the treaty with the United Kingdom considered in 2003, and the treaty with Japan considered in 2004, 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. The treaty with Sri Lanka considered in 2004 contained no exemption for visiting teachers, professors, or researchers.

[27] Sec. 911. Amounts greater than $80,000 generally are included in income for the purpose of computing the U.S. person's tax liability on worldwide income. If the U.S. person paid foreign income taxes, the U.S. person may be able to claim the foreign tax credit for income taxes paid.

The Committee may wish to satisfy itself that such an exemption with respect to Bangladesh is appropriate. Looking beyond the U.S.-Bangladesh treaty relationship, the Committee may wish to determine whether an exemption from host country taxation for visiting teachers and professors is consistent with recent trends in U.S. tax treaty policy. Specifically, the Committee may want to know whether the Treasury Department intends to include such exemptions in other proposed treaties in the future.[28]

[28] *See* Part V.D., below, for a discussion of divergence from the U.S. model tax treaty.

## D. U.S. Model Income Tax Treaty

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

> [T]he Model is not intended to represent an ideal United States income tax treaty. Rather, a principal function of the Model is to facilitate negotiations by helping the negotiators identify differences between income tax policies in the two countries. In this regard, the Model can be especially valuable with respect to the many countries that are conversant with the OECD Model. … Another purpose of the Model and the Technical Explanation is to provide a basic explanation of U.S. treaty policy for all interested parties, regardless of whether they are prospective treaty partners.[29]

U.S. model tax treaties provide a framework for U.S. treaty policy. These models provide helpful information to taxpayers, the Congress, and foreign governments as to U.S. policies on often complicated treaty matters. In order to promote clarity, transparency, and meaningful Congressional oversight in this area, the U.S. model tax treaties should reflect the most current positions on U.S. treaty policy. Periodically updating the U.S. model tax treaties to reflect changes, revisions, developments, and the viewpoints of Congress with regard to U.S. treaty policy would ensure that the model treaties remain meaningful and relevant.[30]

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

It is recognized that tax treaties often diverge from the U.S. model due to, among other things, the unique characteristics of the legal and tax systems of treaty partners, the outcome of negotiations with treaty partners, and recent developments in U.S. treaty policy. However, even without taking into account the central features of tax treaties that predictably diverge from the U.S. model (e.g., withholding rates, limitation on benefits, exchange of information), the

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

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

technical provisions of recent U.S. tax treaties have diverged substantively from the U.S. model with increasing frequency. This development suggests that the U.S. model, which has not been updated since 1996, is becoming obsolete.

In testimony before the Committee in February 2004, the Treasury Department stated that it intended to update the U.S. model, and to work with the staffs of this Committee and the Joint Committee on Taxation in this regard.[31] In testimony before the Committee in September 2004, the Treasury Department stated that it had begun work on an update to the U.S. model, and was looking forward to working with the staffs of this Committee and the Joint Committee on Taxation on this project.[32] The Committee may wish to inquire of the Treasury Department as to the current status of this project.

[31] Testimony of Barbara M. Angus, International Tax Counsel, U.S. Treasury Department, Before the Senate Committee on Foreign Relations Hearing on Pending Income Tax Agreements, February 25, 2004.

[32] Testimony of Barbara M. Angus, International Tax Counsel, U.S. Treasury Department, Before the Senate Committee on Foreign Relations Hearing on Pending Income Tax Agreements, September 24, 2004.