

DEPARTMENT OF THE TREASURY
TECHNICAL EXPLANATION OF THE CONVENTION BETWEEN
THE UNITED STATES OF AMERICA
AND
THE REPUBLIC OF ESTONIA
FOR THE AVOIDANCE OF DOUBLE TAXATION AND
THE PREVENTION OF FISCAL EVASION
WITH RESPECT TO TAXES ON INCOME

This is a technical explanation of the Convention between the United States and the Republic of Estonia signed on January 15, 1998 (the "Convention").

Negotiations took into account the U.S. Treasury Department's current tax treaty policy and the U.S. Treasury Department's Model Income Tax Convention published on September 20, 1996 (the "U.S. Model") between the first and second rounds of negotiations for this Convention, as well as the Model Income Tax Convention On Income and On Capital published by the Organization for Economic Cooperation and Development, as updated in November, 1997 (the "OECD Model") and recent tax treaties concluded by both countries.

The Technical Explanation is an official guide to the Convention. It reflects the policies behind particular Convention provisions, as well as understandings reached with respect to the application and interpretation of the Convention. References in the Technical Explanation to "he" or "his" should be read to mean "he or she" or "his or her".

ARTICLE 1 (GENERAL SCOPE)

Paragraph 1

Paragraph 1 of Article 1 provides that the Convention applies to residents of the United States or Estonia except where the terms of the Convention provide otherwise. Under Article 4 (Resident) a person is generally treated as a resident of a Contracting State if that person is, under the laws of that State, liable to tax therein by reason of his domicile or other similar criteria. If, however, a person is considered a resident of both Contracting States, Article 4 provides rules for determining a single state of residence (or no state of residence). This determination governs for all purposes of the Convention.

Certain provisions are applicable to persons who may not be residents of either Contracting State. For example, Article 19 (Government Service) may apply to an employee of a Contracting State who is resident in neither State. Paragraph 1 of Article 24 (Nondiscrimination) applies to nationals of the Contracting States. Under Article 26 (Exchange of Information and Administrative Assistance), information may be exchanged with respect to residents of third states.

Paragraph 2

Paragraph 2 states the generally accepted relationship between the Convention and domestic law and between the Convention and other agreements between the Contracting States (*i.e.*, that no provision in the Convention may restrict any benefit accorded by the tax laws of the Contracting States, or by any other agreement between the Contracting States.) The list in paragraph 2 contains examples of benefits not to be restricted and is not intended to be exhaustive. For example, if a deduction would be allowed under the U.S. Internal Revenue Code (the "Code") in computing the U.S. taxable income of a resident of Estonia, the deduction also is allowed to that person in computing taxable income under the Convention. Paragraph 2 also means that the Convention may not increase the tax burden on a resident of a Contracting State beyond the burden determined under domestic law. Thus, a right to tax given by the Convention cannot be exercised unless that right also exists under internal law. The relationship between the non-discrimination provisions of the Convention and other agreements is not addressed in paragraph 2 but in paragraph 3.

It follows that under the principle of paragraph 2 a taxpayer's liability to U.S. tax need not be determined under the Convention if the Code would produce a more favorable result. A taxpayer may not, however, choose among the provisions of the Code and the Convention in an inconsistent manner in order to minimize tax. For example, assume that a resident of Estonia has three separate businesses in the United States. One is a profitable permanent establishment and the other two are trades or businesses that would earn taxable income under the Code but that do not meet the permanent establishment threshold tests of the Convention. One is profitable and the other incurs a loss. Under the Convention, the income of the permanent establishment is taxable, and both the profit and loss of the other two businesses are ignored. Under the Code, all three would be subject to tax, but the loss would be offset against the profits of the two profitable ventures. The taxpayer may not invoke the Convention to exclude the profits of the profitable trade or business and invoke the Code to claim the loss of the loss trade or business against the profit of the permanent establishment. (See Rev. Rul. 84-17, 1984-1 C.B. 308.) If, however, the taxpayer invokes the Code for the taxation of all three ventures, he would not be precluded from invoking the Convention 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.

Similarly, nothing in the Convention can be used to deny any benefit granted by any other agreement between the United States and the other Contracting State. For example, if certain benefits are provided for diplomats under a Consular Convention between the United States and Estonia, those benefits or protections will be available to residents of the Contracting States regardless of any provisions to the contrary (or silence) in the Convention.

Paragraph 3

Paragraph 3 specifically relates to non-discrimination obligations of the Contracting States under other agreements. The provisions of paragraph 3 are an exception to the rule provided in paragraph 2 of this Article under which the Convention shall not restrict in any manner any benefit now or hereafter accorded by any other agreement between the Contracting States.

Subparagraph (a) of paragraph 3 provides that, notwithstanding any other agreement to which the Contracting States may be parties, a dispute concerning whether a measure is within the scope of this Convention shall be considered only by the competent authorities of the Contracting States, and the procedures under this Convention exclusively shall apply to the dispute. Thus, procedures for dealing with disputes that may be incorporated into trade, investment, or other agreements between the Contracting States shall not apply for the purpose of determining the scope of the Convention.

Subparagraph (b) of paragraph 3 provides that, unless the competent authorities determine that a taxation measure is not within the scope of this Convention, the nondiscrimination obligations of this Convention exclusively shall apply with respect to that measure, except for such national treatment or most-favored-nation ("MFN") obligations as may apply to trade in goods under the General Agreement on Tariffs and Trade ("GATT"). No national treatment or MFN obligation under any other agreement shall apply with respect to that measure. Thus, unless the competent authorities agree otherwise, any national treatment and MFN obligations undertaken by the Contracting States under agreements other than the Convention shall not apply to a taxation measure, with the exception of GATT as applicable to trade in goods.

Subparagraph (c) of paragraph 3 defines a "measure" broadly. It would include, for example, a law, regulation, rule, procedure, decision, administrative action or guidance, or any other form of governmental guidance.

Paragraph 4

Paragraph 4 contains the traditional saving clause found in U.S. tax treaties. The Contracting States reserve their rights, except as provided in paragraph 5, to tax their residents and citizens as provided in their internal laws, notwithstanding any provisions of the Convention to the contrary. For example, if a resident of Estonia performs independent personal services in the United States and the income from the services is not attributable to a fixed base in the United States, Article 14 (Independent Personal Services) would by its terms prevent the United States from taxing the income. If, however, the Estonian resident is also a citizen of the United States, the saving clause permits the United States to include the remuneration in the worldwide income of the citizen and subject it to tax under the normal Code rules (i.e., without regard to Code section 894(a)).

For purposes of the saving clause, "residence" is determined under Article 4 (Resident). Thus, if an individual who is not a U.S. citizen is a resident of the United States under the Code, and is also a resident of Estonia under its law, and that individual has a permanent home available to him in Estonia and not in the United States, he would, under the tie-breaker rules of Article 4 (Resident), be treated as a resident of Estonia under Article 4 and for purposes of the saving clause. The United States would not be permitted to apply its statutory rules to that person if they are inconsistent with the treaty. Such an individual would be subject to U.S. tax only to the extent permitted by the Convention. However, that person would be treated as a U.S. resident for U.S. tax purposes other than determining the individual's U.S. tax liability. For example, in determining under Code section 957 whether a foreign corporation is a controlled foreign corporation, shares in that corporation held by the individual would be considered to be held by a U.S. resident. As a result, other U.S. citizens or residents might be deemed to be United States shareholders of a controlled foreign corporation subject to current inclusion of Subpart F income recognized by the corporation. See, Treas. Reg. section 301.7701(b)-7(a)(3).

Under paragraph 4 each Contracting State also reserves its right to tax former citizens and long-term residents whose loss of citizenship or long-term residence had as one of its principal purposes the avoidance of tax. Consistent with paragraph 2 of Article 3 (General Definitions), the phrase "as one of its principal purposes the avoidance of tax" as used in paragraph 4 was understood by the negotiators to be defined under the laws of the Contracting State of which the person was a citizen or long-term resident. The United States treats an individual as having a principal purpose to avoid tax if (a) the average annual net income tax of such individual for the period of 5 taxable years ending before the date of the loss of status is greater than \$100,000, or (b) the net worth of such individual as of such date is \$500,000 or more. The United States defines "long-term resident" as an individual (other than a U.S. citizen) who is a lawful permanent resident of the United States in at least 8 of the prior 15 taxable years. An individual shall not be treated as a lawful permanent resident for any taxable year if such individual is treated as a resident of a foreign country under the provisions of a tax treaty between the United States and the foreign country and the individual does not waive the benefits of such treaty applicable to residents of the foreign country. In the United States, such a former citizen or long-term resident is taxable in accordance with the provisions of section 877 of the Code.

Paragraph 5

Some provisions are intended to provide benefits to citizens and residents even if such benefits do not exist under internal law. Paragraph 5 sets forth certain exceptions to the saving clause that preserve these benefits for citizens and residents of the Contracting States. Sub-paragraph (a) lists certain provisions of the Convention that are applicable to all citizens and residents of a Contracting State, despite the general saving clause rule of paragraph 4: (1) Paragraph 2 of Article 9 (Associated Enterprises) grants the right to a correlative adjustment with respect to income tax due on profits reallocated under Article 9. (2) Paragraphs 2 and 5 of Article 18 (Pensions, Social Security, Annuities, Alimony and Child Support) deal with social security benefits and child support payments, respectively. The inclusion of paragraph 2 in the

exceptions to the saving clause means that the grant of exclusive taxing right of social security benefits to the paying country applies to deny, for example, to the United States the right to tax its citizens and residents on social security benefits paid by Estonia. The inclusion of paragraph 5, which exempts child support payments from taxation by the State of residence of the recipient, means that if a resident of Estonia pays child support to a citizen or resident of the United States, the United States may not tax the recipient. (3) Article 23 (Relief from Double Taxation) confirms the benefit of a credit to citizens and residents of one Contracting State for income taxes paid to the other. (4) Article 24 (Nondiscrimination) requires one Contracting State to grant national treatment to residents and citizens of the other Contracting State in certain circumstances. Excepting this Article from the saving clause requires, for example, that the United States give such benefits to a resident or citizen of Estonia even if that person is a citizen of the United States. (5) Article 25 (Mutual Agreement Procedure) may confer benefits on citizens and residents of the Contracting States. For example, the statute of limitations may be waived for refunds and the competent authorities are permitted to use a definition of a term that differs from the internal law definition. As with the foreign tax credit, these benefits are intended to be granted by a Contracting State to its citizens and residents.

Subparagraph (b) of paragraph 5 provides a different set of exceptions to the saving clause. The benefits referred to are all intended to be granted to temporary residents of a Contracting State (for example, in the case of the United States, holders of non-immigrant visas), but not to citizens or to persons who have acquired permanent residence in that State. If beneficiaries of these provisions travel from one of the Contracting States to the other, and remain in the other long enough to become residents under its internal law, but do not acquire permanent residence status (*i.e.*, in the U.S. context, they do not become "green card" holders) and are not citizens of that State, the host State will continue to grant these benefits even if they conflict with the statutory rules. The benefits preserved by this paragraph are the host country exemptions for the following items: government service salaries and pensions under Article 19 (Government Service); certain income of visiting students and trainees under Article 20 (Students, Trainees and Researchers); and the income of diplomatic agents and consular officers under Article 27 (Members of Diplomatic Missions and Consular Posts)

ARTICLE 2 (TAXES COVERED)

This Article specifies the U.S. and Estonian taxes to which the Convention applies. With two exceptions, the taxes specified in Article 2 are the covered taxes for all purposes of the Convention. A broader coverage applies, however, for purposes of Articles 24 (Nondiscrimination) and 26 (Exchange of Information and Administrative Assistance). Article 24 applies with respect to all taxes, including those imposed by state and local governments. Article 26 applies with respect to all taxes imposed at the national level.

Paragraph 1

Subparagraph 1(a) provides that the United States covered taxes are the Federal income taxes imposed by the Code, together with the excise taxes imposed with respect to the investment income of private foundations (Code sections 4940 through 4948). Although they may be regarded as income taxes, social security taxes (Code sections 1401, 3101, 3111 and 3301) are specifically excluded from coverage, as are the accumulated earnings tax and the personal holding company tax. The U.S. covered taxes are referred to in the Convention as "United States Tax."

Subparagraph 1(b) specifies the existing taxes of Estonia that are covered by the Convention. They are the income tax (but excluding the tax on insurance companies provided in paragraph 35 of the Estonian income tax law), and the local income. They are referred to in the Convention as "Estonian tax."

Paragraph 2

Under paragraph 2, the Convention will apply to any taxes that are identical, or substantially similar, to those enumerated in paragraph 1, and which are imposed in addition to, or in place of, the existing taxes after the date of signature of the Convention. The paragraph also provides that the competent authorities of the Contracting States will notify each other of significant changes in their taxation laws or of other laws that affect their obligations under the Convention. The use of the term "significant" means that changes must be reported that are of significance to the operation of the Convention. Other laws that may affect a Contracting State's obligations under the Convention may include, for example, laws affecting bank secrecy.

The competent authorities are also obligated to notify each other of official published materials concerning the application of the Convention. This requirement encompasses materials such as technical explanations, regulations, rulings and judicial decisions relating to the Convention.

ARTICLE 3 (GENERAL DEFINITIONS)

Paragraph 1 defines a number of basic terms used in the Convention. Certain others are defined in other articles of the Convention. For example, the term "resident of a Contracting State" is defined in Article 4 (Resident). The term "permanent establishment" is defined in Article 5 (Permanent Establishment). The terms "dividends," "interest" and "royalties" are defined in Articles 10, 11 and 12, respectively. The introduction to paragraph 1 makes clear that these definitions apply for all purposes of the Convention, unless the context requires otherwise. This latter condition allows flexibility in the interpretation of the treaty in order to avoid unintended results. Terms that are not defined in the Convention are dealt with in paragraph 2.

Paragraph 1

The term "Contracting State" is defined in subparagraph 1(a) to mean either the United States or Estonia, depending on the context in which the term is used.

The term "United States" is defined in subparagraph 1(b) to mean the United States of America, including the states, the District of Columbia and the territorial sea of the United States. The term does not include Puerto Rico, the Virgin Islands, Guam or any other U.S. possession or territory. The geographical meaning of the term United States also includes the territorial sea of the United States, and for certain purposes, the definition is extended to include the sea bed and subsoil of undersea areas adjacent to the territorial sea of the United States. This extension applies to the extent that the United States exercises sovereignty in accordance with international law for the purpose of natural resource exploration and exploitation of such areas. This extension of the definition applies, however, only if the person, property or activity to which the Convention is being applied is connected with such natural resource exploration or exploitation. Thus, it would not include any activity involving the sea floor of an area over which the United States exercised sovereignty for natural resource purposes if that activity was unrelated to the exploration and exploitation of natural resources.

The term "Estonia" is defined in subparagraph 1(c). The term means the Republic of Estonia, and, when used in a geographical sense, means the territory of the Republic of Estonia and any other area adjacent to the territorial waters of the Republic of Estonia within which under the laws of Estonia and in accordance with international law, the rights of Estonia may be exercised with respect to the sea bed and its sub-soil and their natural resources.

Subparagraph 1(d) defines the term "person" to include an individual, an estate, a trust, a partnership, a company and any other body of persons. The definition is significant for a variety of reasons. For example, under Article 4, only a "person" can be a "resident" and therefore eligible for most benefits under the treaty. Also, all "persons" are eligible to claim relief under Article 25 (Mutual Agreement Procedure).

The term "company" is defined in subparagraph 1(e) as a body corporate or an entity treated as a body corporate for tax purposes. Although the Convention does not add "in the State in which it is organized," as does the U.S. Model, the result should be the same, as the Commentaries to the OECD Model interpret the language identical to that of the Convention in a manner consistent with the U.S. Model.

The terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" are defined in subparagraph 1(f) as an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State. The term "enterprise" is not defined in the Convention, nor is it defined in the OECD Model or its Commentaries. Despite the absence of a clear, generally accepted meaning for the term "enterprise," the term is understood to refer to any activity or set of activities that constitute a trade or business.

Although subparagraph 1(f) does not include the U.S. Model's explicit reference to fiscally transparent enterprises, the negotiators understood that the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" encompass an enterprise conducted through an entity (such as a partnership) that is treated as fiscally transparent in the Contracting State where the entity's owner is resident. In accordance with Article 4 (Resident), entities that are fiscally transparent in the country in which their owners are resident are not considered to be residents of a Contracting State (although income derived by such entities may be taxed as the income of a resident, if taxed in the hands of resident partners or other owners). This treatment ensures that an enterprise conducted by such an entity will be treated as carried on by a resident of a Contracting State to the extent its partners or other owners are residents. This approach is consistent with the Code, which under section 875 attributes a trade or business conducted by a partnership to its partners and a trade or business conducted by an estate or trust to its beneficiaries.

An enterprise of a Contracting State need not be carried on in that State. It may be carried on in the other Contracting State or a third state (e.g., a U.S. corporation doing all of its business in Estonia would still be a U.S. enterprise).

Subparagraph 1(g) defines the term "international traffic." The term means any transport by a ship or an aircraft operated by an enterprise of a Contracting State except when the transport is operated solely between places within a Contracting State. This definition is applicable principally in the context of Article 8 (Shipping and Air Transport). Shipping and air transport not operated by an enterprise (i.e., a resident) of a Contracting State is excluded from the definition of international traffic in the Convention, whereas the U.S. Model definition of international traffic includes all income from shipping and air transport, other than transport solely between places in a Contracting State, whether or not the operator is a resident of the Contracting States. This narrower definition in the Convention, when applied in the context of paragraph 1 of Article 8, limits the exclusive residence country taxation under Article 8 of income from the lease of ships and aircraft to lease income derived by a resident of a Contracting State that operates ships or aircraft in international traffic. Income from the lease of ships or aircraft that is derived by a lessor that is not an operator of ships or aircraft in international traffic would not fall under Article 8.

The narrower definition of international traffic similarly combines with paragraph 3 of Article 8 (Shipping and Air Transport) to limit the exclusive residence country taxation under Article 8 to income from the use, maintenance or rental of containers derived by persons engaged in international traffic (i.e., persons engaged in the operation of ships or aircraft in international traffic).

The exclusion from international traffic of transport solely between places within a Contracting State means, for example, that carriage of goods or passengers solely between New York and Chicago would not be treated as international traffic, whether carried by a U.S. or a Estonian carrier. The substantive taxing rules of the Convention relating to the taxation of income from transport, principally Article 8 (Shipping and Air Transport), therefore, would not apply to

income from such carriage. Thus, if the carrier engaged in internal U.S. traffic were a resident of Estonia (assuming that were possible under U.S. law), the United States would not be required to exempt the income from that transport under Article 8. The income would, however, be treated as business profits under Article 7 (Business Profits), and therefore would be taxable in the United States only if attributable to a U.S. permanent establishment of the Estonian carrier, and then only on a net basis. The gross basis U.S. tax imposed by section 887 would never apply under the circumstances described. If, however, goods or passengers are carried by a carrier resident in Estonia from a non-U.S. port to, for example, New York, and some of the goods or passengers continue on to Chicago, the entire transport would be international traffic. This would be true if the international carrier transferred the goods at the U.S. port of entry from a ship to a land vehicle, from a ship to a lighter, or even if the overland portion of the trip in the United States was handled by an independent carrier under contract with the original international carrier, so long as both parts of the trip were reflected in original bills of lading. For this reason, the Convention refers, in the definition of "international traffic," to "such transport" being solely between places in the other Contracting State, while the OECD Model refers to the ship or aircraft being operated solely between such places. The language of the Convention, based on U.S. Model language, is intended to make clear that, as in the above example, even if the goods are carried on a different aircraft for the internal portion of the international voyage than is used for the overseas portion of the trip, the definition applies to that internal portion as well as the external portion.

Finally, a "cruise to nowhere," *i.e.*, a cruise beginning and ending in a port in the same Contracting State with no stops in a foreign port, would not constitute international traffic.

Subparagraphs 1(h)(i) and (ii) define the term "competent authority" for the United States and Estonia, respectively. The U.S. competent authority is the Secretary of the Treasury or his delegate. The 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 Assistant Commissioner (International). With respect to interpretative issues, the Assistant Commissioner acts with the concurrence of the Associate Chief Counsel (International) of the Internal Revenue Service. The Estonian competent authority is the Minister of Finance or his authorized representative.

The term "national," as it relates to the United States and to Estonia, is defined in subparagraphs 1(i)(i) and (ii). This term is relevant for purposes of Articles 19 (Government Service) and 24 (Non-discrimination). A national of one of the Contracting States is (1) an individual who is a citizen or national of that State, (2) any legal person, partnership or association deriving its status as such from the law in force in the State where it is established, and in the case of Estonia only, (3) a personal enterprise without rights of a legal person deriving its status as such from the laws in force in a Contracting State.

Paragraph 2

Paragraph 2 provides that in the application of the Convention, any term used but not defined in the Convention will have the meaning that it has under the law of the Contracting State whose tax is being applied, unless the context requires otherwise. The paragraph makes clear that if the term is defined under both the tax and non-tax laws of a Contracting State, the definition in the tax law will take precedence over the definition in the non-tax laws. Finally, there also may be cases where the tax laws of a State contain multiple definitions of the same term. In such a case, the definition used for purposes of the particular provision at issue, if any, should be used.

If the meaning of a term cannot be readily determined under the law of a Contracting State, or if there is a conflict in meaning under the laws of the two States that creates difficulties in the application of the Convention, the competent authorities, as indicated in paragraph 3(f) of Article 25 (Mutual Agreement Procedure), may establish a common meaning in order to prevent double taxation or to further any other purpose of the Convention. This common meaning need not conform to the meaning of the term under the laws of either Contracting State.

The reference in paragraph 2 to the internal law of a Contracting State means the law in effect at the time the treaty is being applied, not the law as in effect at the time the treaty was signed. This use of "ambulatory" definitions, however, may lead to results that are at variance with the intentions of the negotiators and of the Contracting States when the treaty was negotiated and ratified. The reference in both paragraphs 1 and 2 to the "context otherwise requiring" a definition different from the treaty definition, in paragraph 1, or from the internal law definition of the Contracting State whose tax is being imposed, under paragraph 2, refers to a circumstance where the result intended by the Contracting States is different from the result that would obtain under either the paragraph 1 definition or the statutory definition. Thus, flexibility in defining terms is necessary and permitted.

ARTICLE 4 (RESIDENT)

This Article sets forth rules for determining whether a person is a resident of a Contracting State for purposes of the Convention. As a general matter only residents of the Contracting States may claim the benefits of the Convention. The treaty definition of residence is to be used only for purposes of the Convention. The fact that a person is determined to be a resident of a Contracting State under Article 4 does not necessarily entitle that person to the benefits of the Convention. In addition to being a resident, a person also must qualify for benefits under Article 22 (Limitation on Benefits) in order to receive benefits conferred on residents of a Contracting State.

The determination of residence for treaty purposes looks first to a person's liability to tax as a resident under the respective taxation laws of the Contracting States. As a general matter, a person who, under those laws, is a resident of one Contracting State and not of the other need look no further. For purposes of the Convention that person is a resident of the State in which he is resident under internal law. If, however, a person is resident in both Contracting States under

their respective taxation laws, the Article proceeds, where possible, to use tie-breaker rules to assign a single State of residence to such a person for purposes of the Convention.

Paragraph 1

The term "resident of a Contracting State" is defined in paragraph 1. In general, this definition incorporates the definitions of residence in U.S. law and that of Estonia by referring to a resident as a person who, under the laws of a Contracting State, is subject to tax there by reason of his residence, domicile, citizenship, place of management, place of incorporation or any other similar criterion. Thus, residents of the United States include aliens who are considered U.S. residents under Code section 7701(b).

Certain entities that are nominally subject to tax but that in practice rarely pay tax also would generally be treated as residents and therefore accorded treaty benefits. For example, RICs, REITs and REMICs are all residents of the United States for purposes of the treaty. Although the income earned by these entities normally is not subject to U.S. tax in the hands of the entity, they are taxable to the extent that they do not currently distribute their profits, and therefore may be regarded as "liable to tax." They also must satisfy a number of requirements under the Code in order to be entitled to special tax treatment.

Paragraph 2

Paragraph 2 identifies three circumstances where the definition of residence set forth in paragraph 1 does not apply or is limited.

Subparagraph (a) provides that a person who is liable to tax in a Contracting State only in respect of income from sources within that State will not be treated as a resident of that Contracting State for purposes of the Convention. Thus, a consular official of Estonia who is posted in the United States, who may be subject to U.S. tax on U.S. source investment income, but is not taxable in the United States on non-U.S. source income, would not be considered a resident of the United States for purposes of the Convention. (See Code section 7701(b)(5)(B)). Similarly, although not explicitly stated in the Convention, as it is in the U.S. Model, an enterprise of Estonia with a permanent establishment in the United States is not, by virtue of that permanent establishment, a resident of the United States. The enterprise generally is subject to U.S. tax only with respect to its income that is attributable to the U.S. permanent establishment, not with respect to its worldwide income, as it would be if it were a U.S. resident.

Subparagraph (b) addresses special problems presented by transparent entities, such as partnerships, estates and trusts. The entity itself may be treated as a resident of a Contracting State to the extent that the entity is subject to tax in that State on the income as the income of a resident. This subparagraph also applies to any resident of a Contracting State who is subject to tax as a resident of that State on income derived through an entity that is treated as fiscally transparent under the laws of either Contracting State. Entities falling under this description in the United

States would include partnerships, common investment trusts under section 584 and grantor trusts. This paragraph also applies to U.S. limited liability companies (“LLC’s”) that are treated as partnerships for U.S. tax purposes.

Subparagraph (b) provides that an item of income derived through such fiscally transparent entities will be considered to be derived by a resident of a Contracting State if the resident is treated under the taxation laws of the State where he is resident as deriving the item of income.

For example, if an Estonian corporation distributes a dividend to an entity that is treated as fiscally transparent for U.S. tax purposes, the dividend will be considered to be derived by a resident of the U.S. only to the extent that U.S. tax law treats one or more U.S. residents (whose status as U.S. residents is determined, for this purpose, under U.S. tax law) as deriving the dividend income for U.S. tax purposes. In the case of a partnership, the persons who are, under U.S. tax law, treated as partners of the entity would normally be the persons whom the U.S. tax law would treat as deriving the dividend income through the partnership. Also, it follows that partners whom the U.S. treats as deriving the dividend income for U.S. tax purposes but who are not U.S. residents under U.S. tax law may not claim a benefit for the dividend paid to the entity under the Convention, because they are not residents of the United States for purposes of claiming this treaty benefit. (If, however, the country in which they are treated as resident for tax purposes, as determined under the laws of that country, has an income tax convention with Estonia, they may be entitled to claim a benefit under that convention.) In contrast, if, for example, an entity is organized under U.S. laws and is classified as a corporation for U.S. tax purposes, dividends paid by a Estonia corporation to the U.S. entity will be considered derived by a resident of the United States since the U.S. corporation is treated under U.S. taxation laws as a resident of the United States and as deriving the income.

These results would obtain even if the entity were viewed differently under the tax laws of Estonia (e.g., as not fiscally transparent in the first example above where the entity is treated as a partnership for U.S. tax purposes or as fiscally transparent in the second example where the entity is viewed as not fiscally transparent for U.S. tax purposes). Similarly, the characterization of the entity in a third country is also irrelevant, even if the entity is organized in that third country. The results obtain regardless of whether the entity is disregarded as a separate entity under the laws of one jurisdiction but not the other, such as a single owner entity that is viewed as a branch for U.S. tax purposes and as a corporation for Estonian tax purposes. The results also obtain regardless of where the entity is organized, i.e., in the United States, in Estonia, or in a third country.

For example, income from Estonian sources received by an entity organized under the laws of Estonia, 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 Estonia, the entity is treated as fiscally transparent. Rather, for purposes of the Convention, the income is treated as derived by the Estonian entity.

The rule also applies to trusts to the extent that they are fiscally transparent in either Contracting State. For example, if X, a resident of Estonia, creates a revocable trust and names persons resident in a third country as the beneficiaries of the trust, X would be treated as the beneficial owner of income derived from the United States under the Code's rules. If Estonia has no rules comparable to those in sections 671 through 679 of the Code then it is possible that under Estonian law neither X nor the trust would be taxed on the income derived from the United States. In these cases it is to be understood that the trust's income would be regarded as being derived by a resident of Estonia only to the extent that the laws of Estonia treat Estonian residents as deriving the income for tax purposes.

The taxation laws of a Contracting State may treat an item of income, profit or gain as income, profit or gain of a resident of that State even if the resident is not subject to tax on that particular item of income, profit or gain. For example, if a Contracting State has a participation exemption for certain foreign-source dividends and capital gains, such income or gains would be regarded as income or gain of a resident of that State who otherwise derived the income or gain, despite the fact that the resident could be exempt from tax in that State on the income or gain.

Income is "derived through" a fiscally transparent entity if the entity's participation in the transaction giving rise to the income, profit or gain in question is respected after application of any source State anti-abuse principles based on substance over form and similar analyses. For example, if a partnership with U.S. partners receives income arising in Estonia, that income will be considered to be derived through the partnership by its partners as long as the partnership's participation in the transaction is not disregarded for lack of economic substance. In such a case, the partners would be considered to be the beneficial owners of the income.

A U.S. citizen would generally be treated as a resident of the United States under paragraph 1. However, subparagraph 2(c) provides that a U.S. citizen or alien lawfully admitted for permanent residence (*i.e.*, a "green card" holder) who is not, under the introductory language of paragraph 1 of this Article, an individual resident of Estonia will be treated as a resident of the United States for purposes of the Convention, and, thereby entitled to treaty benefits, only if he has a substantial presence (see section 7701(b)(3)), permanent home or habitual abode in the United States. If, however, such an individual is a resident both of the United States and Estonia under the general rule of paragraph 1, whether he is to be treated as a resident of the United States or of Estonia for purposes of the Convention is determined by the tie-breaker rules of paragraph 4 of the Article, regardless of how close his nexus to the United States may be. However, the fact that a U.S. citizen who does not have close ties to the United States may not be treated as a U.S. resident under the Convention does not alter the application of the saving clause of paragraph 4 of Article 1 (General Scope) to that citizen. For example, a U.S. citizen who pursuant to the "citizen/green card holder" rule is not considered to be a resident of the United States still is taxable on his worldwide income under the generally applicable rules of the Code.

Paragraph 3

Subparagraph (a) makes clear the generally understood practice of including within the term “resident of a Contracting State” the Government of that state as well as any political subdivisions or local authorities, agencies and other instrumentalities of that State.

Subparagraph (b) provides that certain tax-exempt entities such as pension funds and charitable organizations will also be regarded as residents of a Contracting State regardless of whether they are generally liable for income tax in the State where they are established. An entity is dealt with in this subparagraph if it is generally exempt from tax by reason of the fact that it is organized and operated exclusively to perform a charitable or similar purposes, or to provide pension or similar benefits to employees pursuant to a plan. The reference to “similar benefits” is intended to encompass employee benefits such as health and disability benefits.

The inclusion of this provision is intended to clarify the generally accepted practice of treating an entity that would be liable for tax as a resident under the internal law of a state but for a specific exemption from tax (either complete or partial) as a resident of that state for purposes of paragraph 1. The reference to a “general” exemption is intended to reflect the fact that under U.S. law, certain organizations that generally are considered to be tax-exempt entities may be subject to certain excise taxes or to income tax on their unrelated business income. Thus, a U.S. pension trust, or an exempt section 501(c) organization (such as a U.S. charity) that is generally exempt from tax under U.S. law is considered a resident of the United States for all purposes of the treaty.

Paragraph 4

If, under the laws of the two Contracting States, and, thus, under paragraph 1, an individual is deemed to be a resident of both Contracting States, a series of tie-breaker rules are provided in paragraph 4 to determine a single State of residence for that individual. These tests are to be applied in the order in which they are stated. The first test is based on where the individual has a permanent home. If that test is inconclusive because the individual has a permanent home available to him in both States, he will be considered to be a resident of the Contracting State where his personal and economic relations are closest (*i.e.*, the location of his "center of vital interests"). If that test is also inconclusive, or if he does not have a permanent home available to him in either State, he will be treated as a resident of the Contracting State where he maintains an habitual abode. If he has an habitual abode in both States or in neither of them, he will be treated as a resident of the Contracting State of which he is a national. If he is a national of both States or of neither, the matter will be considered by the competent authorities, who will assign a single State of residence.

Paragraph 5

Paragraph 5 seeks to settle dual-residence issues for companies. A company is treated as a resident in the United States if it is created or organized under the laws of the United States or a political subdivision thereof. In Estonia, a corporation is treated as a resident of Estonia if it is either incorporated there or managed and controlled there. Dual residence, therefore, can arise if a

U.S.-incorporated corporation is managed and controlled in Estonia. The paragraph provides that if a company is resident in both the United States and Estonia under paragraph 1, the competent authorities shall seek to determine a single State of residence for the company for purposes of the Convention. If, however, they are unable to reach agreement, then the company shall not be considered to be a resident of either the United States or Estonia for purposes of deriving any benefits of the Convention. Since it is only for the purposes of deriving treaty benefits that such dual residents are excluded from the Convention, they may be treated as resident for other purposes. For example, if a dual resident corporation pays a dividend to a resident of Estonia, the U.S. withholding agent would be permitted to withhold on that dividend at the appropriate treaty rate, since reduced withholding is a benefit enjoyed by the resident of Estonia receiving the dividend, not by the dual resident. The dual resident corporation that pays the dividend would, for this purpose, be treated as a resident of the United States under the Convention.

Paragraph 6

Dual residents other than individuals or companies (such as trusts or estates) are addressed by paragraph 6. If such a person is, under the rules of paragraph 1, resident in both Contracting States, the competent authorities shall seek to determine a single State of residence for that person for purposes of the Convention.

ARTICLE 5 (PERMANENT ESTABLISHMENT)

This Article defines the term "permanent establishment," a term that is significant for several articles of the Convention. The existence of a permanent establishment in a Contracting State is necessary under Article 7 (Business Profits) for the taxation by that State of the business profits of a resident of the other Contracting State. Since the term "fixed base" in Article 14 (Independent Personal Services) is generally understood by reference to the definition of "permanent establishment," this Article is also relevant for purposes of Article 14. Articles 10, 11 and 12 (dealing with dividends, interest, and royalties, respectively) provide for reduced rates of tax at source on payments of these items of income to a resident of the other State only when the income is not attributable to a permanent establishment or fixed base that the recipient has in the source State. The concept is also relevant in determining which Contracting State may tax certain gains under Article 13 (Capital Gains) and certain "other income" under Article 21 (Other Income).

The Article follows closely both the OECD Model and the U.S. Model provisions.

Paragraph 1

The basic definition of the term "permanent establishment" is contained in paragraph 1. As used in the Convention, the term means a fixed place of business through which the business of an enterprise is wholly or partly carried on. As indicated in the OECD Commentaries (see paragraphs

4 through 8), a general principle to be observed in determining whether a permanent establishment exists is that the place of business must be “fixed” in the sense that a particular building or physical location is used by the enterprise for the conduct of its business, and that it must be foreseeable that the enterprise’s use of this building or other physical location will be more than temporary.

Paragraph 2

Paragraph 2 lists a number of types of fixed places of business that constitute a permanent establishment. This list is illustrative and non-exclusive. According to paragraph 2, the term permanent establishment includes a place of management, a branch, an office, a factory, a workshop, and a mine, oil or gas well, quarry or other place of extraction of natural resources.

Paragraph 3

This paragraph provides rules to determine whether a building site or a construction, assembly or installation project, or a drilling rig or ship used for the exploration of natural resources constitutes a permanent establishment for the contractor, driller, etc. An activity is merely preparatory and does not create a permanent establishment under paragraph 4(e) unless the site, project, etc. lasts or continues for more than six months. It is only necessary to refer to "exploration" and not "exploitation" in this context because exploitation activities are defined to constitute a permanent establishment under subparagraph (f) of paragraph 2. Thus, a drilling rig does not constitute a permanent establishment if a well is drilled in only six months, but if production begins in the following month the well becomes a permanent establishment as of that date.

The six-month test applies separately to each site or project. The six-month period begins when work (including preparatory work carried on by the enterprise) physically begins in a Contracting State. A series of contracts or projects by a contractor that are interdependent both commercially and geographically are to be treated as a single project for purposes of applying the six-month threshold test. For example, the construction of a housing development would be considered a single project even if each house were constructed for a different purchaser.

If the six-month threshold is exceeded, the site or project constitutes a permanent establishment from the first day of activity. In applying this paragraph, time spent by a sub-contractor on a building site is counted as time spent by the general contractor at the site for purposes of determining whether the general contractor has a permanent establishment. However, for the sub-contractor itself to be treated as having a permanent establishment, the sub-contractor's activities at the site must last for more than six months. If a sub-contractor is on a site intermittently, then, time is measured from the first day the sub-contractor is on the site until the last day (*i.e.*, intervening days that the sub-contractor is not on the site are counted) for purposes of applying the six-month rule.

These interpretations of the Article are based on the Commentary to paragraph 3 of Article 5 of the OECD Model, which, with the differences from the U.S. Model noted above, contains

language substantially the same as that in the Convention. These interpretations are consistent with the generally accepted international interpretation of the relevant language in paragraph 3 of Article 5 of the Convention.

Paragraph 4

This paragraph contains exceptions to the general rule of paragraph 1, listing a number of activities that may be carried on through a fixed place of business, but which nevertheless do not create a permanent establishment. The use of facilities solely to store, display or deliver merchandise belonging to an enterprise does not constitute a permanent establishment of that enterprise. The maintenance of a stock of goods belonging to an enterprise solely for the purpose of storage, display or delivery, or solely for the purpose of processing by another enterprise does not give rise to a permanent establishment of the first-mentioned enterprise. The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or for collecting information, for the enterprise, or for other activities that have a preparatory or auxiliary character for the enterprise, such as advertising, or the supply of information, do not constitute a permanent establishment of the enterprise. Thus, as explained in paragraph 22 of the OECD Commentaries, a news bureau of a newspaper would not constitute a permanent establishment of the news organization.

Subparagraph 4(f) provides that a combination of the activities described in the other subparagraphs of paragraph 4 will not give rise to a permanent establishment if the combination results in an overall activity that is of a preparatory or auxiliary character. This combination rule, derived from the OECD Model, differs from that in the U.S. Model. In the U.S. Model, any combination of otherwise excepted activities is not deemed to give rise to a permanent establishment, without the additional requirement that the combination, as distinct from each constituent activity, be preparatory or auxiliary. It is assumed that if preparatory or auxiliary activities are combined, the combination generally will also be of a character that is preparatory or auxiliary. If, however, this is not the case, a permanent establishment may result from a combination of activities.

Paragraph 5

Paragraphs 5 and 6 specify when activities carried on by an agent on behalf of an enterprise create a permanent establishment of that enterprise. Under paragraph 5, a dependent agent of an enterprise is deemed to be a permanent establishment of the enterprise if the agent has and habitually exercises an authority to conclude contracts in the name of that enterprise. If, however, the agent's activities are limited to those activities specified in paragraph 4 which would not constitute a permanent establishment if carried on by the enterprise through a fixed place of business, the agent is not a permanent establishment of the enterprise.

The U.S. Model uses the term "binding on the enterprise" rather than "in the name of that enterprise" as used in the OECD model. There is no substantive difference. As indicated in

paragraph 32 to the OECD Commentaries on Article 5, the application of paragraph 5 of the Article is not limited to “an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise, even if those contracts are not actually in the name of the enterprise.”

The contracts referred to in paragraph 5 are those relating to the essential business operations of the enterprise, rather than ancillary activities. For example, if the agent has no authority to conclude contracts in the name of the enterprise with its customers for, say, the sale of the goods produced by the enterprise, but it can enter into service contracts in the name of the enterprise for the enterprise's business equipment used in the agent's office, this contracting authority would not fall within the scope of the paragraph, even if exercised regularly.

Paragraph 6

Under paragraph 6, an enterprise is not deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through an independent agent, including a broker or general commission agent, if the agent is acting in the ordinary course of his business as an independent agent. Thus, there are two conditions that must be satisfied if the agent is not to constitute a permanent establishment of the enterprise: the agent must be both legally and economically independent of the enterprise, and the agent must be acting in the ordinary course of its business in carrying out activities on behalf of the enterprise. As described below, there are additional factors identified in this Convention which, if present, may cause an otherwise independent agent to be treated as a dependent agent.

Whether the agent and the enterprise are independent is a factual determination. Among the questions to be considered are the extent to which the agent operates on the basis of instructions from the enterprise. An agent that is subject to detailed instructions regarding the conduct of its operations or comprehensive control by the enterprise is not legally independent.

In determining whether the agent is economically independent, a relevant factor is the extent to which the agent bears business risk. Business risk refers primarily to risk of loss. An independent agent typically bears risk of loss from its own activities. In the absence of other factors that would establish dependence, an agent that shares business risk with the enterprise, or has its own business risk, is economically independent because its business activities are not integrated with those of the principal. Conversely, an agent that bears little or no risk from the activities it performs is not economically independent and therefore is not described in paragraph 6.

Another relevant factor in determining whether an agent is economically independent is whether the agent has an exclusive or nearly exclusive relationship with the principal. Such a relationship may indicate that the principal has economic control over the agent. A number of principals acting in concert also may have economic control over an agent. The limited scope of the agent's activities and the agent's dependence on a single source of income may indicate that the agent lacks economic independence. The paragraph provides that an agent will be considered a

permanent establishment of an enterprise (under Paragraph 5) when the activities of that agent are devoted wholly or almost wholly on behalf of that enterprise, and the conditions between the agent and the enterprise differ from those which would be made between independent persons (i.e., the agent and the enterprise are not operating at arms length).

It should be borne in mind, however, that in the absence of transactions between the agent and the enterprise under non-arm's length conditions, exclusivity is not in itself a conclusive test: an agent may be economically independent notwithstanding an exclusive relationship with the principal if it has the capacity to diversify and acquire other clients without substantial modifications to its current business and without substantial harm to its business profits. Thus, exclusivity should be viewed merely as a pointer to further investigation of the relationship between the principal and the agent. Each case must be addressed on the basis of its own facts and circumstances

Paragraph 7

This paragraph clarifies that a company that is a resident of a Contracting State is not deemed to have a permanent establishment in the other Contracting State merely because it controls, or is controlled by, a company that is a resident of that other Contracting State, or that carries on business in that other Contracting State. The determination whether a permanent establishment exists is made solely on the basis of the factors described in paragraphs 1 through 6 of the Article. Whether a company is a permanent establishment of a related company, therefore, is based solely on those factors and not on the ownership or control relationship between the companies.

ARTICLE 6 (INCOME FROM IMMOVABLE (REAL) PROPERTY)

This Article deals with the taxation of income from immovable, or real, property. Those two terms should be understood to have the same meaning.

Paragraph 1

The first paragraph of Article 6 states the general rule that income of a resident of a Contracting State derived from real property situated in the other Contracting State may be taxed in the Contracting State in which the property is situated. The paragraph specifies that income from real property includes income from agriculture and forestry. Income from agriculture and forestry are dealt with in Article 6 rather than in Article 7 (Business Profits). Given the availability of the net election in paragraph 6, taxpayers generally should be able to obtain the same tax treatment in the situs country regardless of whether the income is treated as business profits or real property income. Paragraph 3 clarifies that the income referred to in paragraph 1 also means income from any use of real property, including, but not limited to, income from direct use by the owner (in which case income may be imputed to the owner for tax purposes) and rental income from the letting of real property.

This Article does not grant an exclusive taxing right to the situs State; the situs State is merely given the primary right to tax. The Article does not impose any limitation in terms of rate or form of tax on the situs State. It is understood, however, as noted above, that both States either allow or require the taxpayer to be taxed on a net basis.

Paragraph 2

The term "immovable (real) property" is defined in paragraph 2 mainly by reference to the internal law definition in the situs State. In the case of the United States, the term has the meaning given to it by Reg. 1.897-1(b). In addition to the statutory definitions in the two Contracting States, the paragraph specifies certain additional classes of property that, regardless of internal law definitions, are to be included within the meaning of the term for purposes of the Convention. This expanded definition with the exception of the last sentence conforms to that in the OECD Model. The definition of "immovable (real) property" for purposes of Article 6 is more limited than the expansive definition of "real property situated in the Other Contracting State" in paragraph 2 of Article 13 (Capital Gains). The Article 13 term includes not only immovable property as defined in Article 6 but certain other interests in real property.

Paragraph 3

Paragraph 3 makes clear that all forms of income derived from the exploitation of real property are taxable in the Contracting State in which the property is situated. In the case of a net lease of real property, if a net taxation election has not been made, the gross rental payment (before deductible expenses incurred by the lessee) is treated as income from the property. Income from the disposition of an interest in real property, however, is not considered "derived" from real property and is not dealt with in this Article. The taxation of that income is addressed in Article 13 (Capital Gains). Also, the interest paid on a mortgage on real property and distributions by a U.S. Real Estate Investment Trust are not dealt with in Article 6. Such payments would fall under Articles 10 (Dividends), 11 (Interest) or 13 (Capital Gains). Finally, dividends paid by a United States Real Property Holding Corporation are not considered to be income from the exploitation of real property: such payments would fall under Article 10 (Dividends) or 13 (Capital Gains).

Paragraph 4

Paragraph 4 is not found in the U.S. Model, it was inserted at the request of Estonia. It provides that where the ownership of shares or other corporate rights in a company entitles the owner to the enjoyment of immovable property held by the company, any income from the direct use, letting or use in any other form of this right of enjoyment may be taxed in the Contracting State in which the immovable property is situated. This rule is intended to clarify that such income is to be treated as income from immovable property and not as income from movable property. The principal application of this provision is expected to be with respect to the taxation of income from the rental of cooperative apartments by a shareholder in the cooperative, though it would apply to commercial property as well. Under paragraph 5, these rules apply to income from a right

of enjoyment of an enterprise and to income from such a right used for the performance of independent personal services.

Paragraph 5

This paragraph specifies that the basic rule of paragraph 1 (as elaborated in paragraph 3) applies to income from real property of an enterprise and to income from real property used for the performance of independent personal services. This clarifies that the situs country may tax the real property income (including rental income) of a resident of the other Contracting State in the absence of attribution to a permanent establishment or fixed base in the situs State. This provision represents an exception to the general rule under Articles 7 (Business Profits) and 14 (Independent Personal Services) that income must be attributable to a permanent establishment or fixed base, respectively, in order to be taxable in the situs State.

Paragraph 6

This paragraph provides that a resident of one Contracting State that derives real property income from the other may elect, for any taxable year, to be subject to tax in that other State on a net basis, as though the income were attributable to a permanent establishment in that other State. In the United States, the election may be terminated with the consent of the competent authority and such revocation will be granted in accordance with the provisions of Treas. Reg. section 1.871-10(d)(2). In Estonia, such treatment is mandatory.

ARTICLE 7 (BUSINESS PROFITS)

This Article provides rules for the taxation by a Contracting State of the business profits of an enterprise of the other Contracting State.

Paragraph 1

Paragraph 1 states the general rule that business profits (as defined in paragraph 7) of an enterprise of one Contracting State may not be taxed by the other Contracting State unless the enterprise carries on business in that other Contracting State through a permanent establishment (as defined in Article 5 (Permanent Establishment)) situated there. When that condition is met, the State in which the permanent establishment is situated may tax the enterprise on the income that is attributable to the permanent establishment, but only on a net basis.

Under certain circumstances, the State in which the permanent establishment exists may also tax income of the enterprise attributable to sales in that other State of goods or merchandise of the same kind as those sold through the permanent establishment, or to other business transactions carried on in that other State which are of the same or similar kind as those effected through the permanent establishment. These rules are of a type known as "limited force of attraction" rules.

This limited force of attraction rule is similar to, but narrower than, a rule found in the U.N. Model. Under the rule in the U.N. Model, if an enterprise of one Contracting State derives income from the sale of goods or the carrying on of other business activities through a permanent establishment situated in the other Contracting State, income derived directly by the enterprise (i.e., not through the permanent establishment) from the sale of goods of the same or similar kind as those sold through the permanent establishment or from the carrying on of activities of the same or similar kind as those carried on through the permanent establishment may be attributed to the permanent establishment. Countries that insist on including a limited force of attraction rule see it as a means of preventing avoidance of their tax at source. The force of attraction rule in this Convention focuses on its anti-abuse function. Its application is limited to situations in which it can be shown that the transaction giving rise to the income was carried out outside the permanent establishment in order to avoid taxation in the country in which the permanent establishment is situated. For example, if the Tallinn office of a U.S. consulting firm provides certain services to small companies in Estonia and a very large Estonian company requires similar services but on a scale too large for the permanent establishment to handle, the Estonian company might enter into a contract with the consulting firm's home office in the United States to provide those services directly. The income from that transaction would not be attributed to the permanent establishment because it could not be shown that the transaction was structured through the U.S. office in order to avoid Estonian tax. If, however, some small Estonian companies are served by the Tallinn office and other similar-sized companies are served directly from the United States, it might be possible to show that services were carried out through the home office to avoid Estonian tax. If such a case were made, the income from these contracts with the home office would be attributed to the permanent establishment.

The limited force of attraction rule in this Convention is narrower than the rule of Code section 864(c)(3).

Paragraph 2

Paragraph 2 provides rules for the attribution of business profits to a permanent establishment. The Contracting States will attribute to a permanent establishment the profits that it would have earned had it been an independent enterprise engaged in the same or similar activities under the same or similar circumstances. This language incorporates the arm's-length standard for purposes of determining the profits attributable to a permanent establishment. The computation of business profits attributable to a permanent establishment under this paragraph is subject to the rules of paragraph 3 for the allowance of expenses incurred for the purposes of earning the profits.

The "attributable to" concept of paragraph 2 is analogous but not entirely equivalent to the "effectively connected" concept in Code section 864(c). The profits attributable to a permanent establishment may be from sources within or without a Contracting State.

It is understood that the business profits attributed to a permanent establishment include only those profits derived from that permanent establishment's assets or activities. This rule is

consistent with the "asset-use" and "business activities" test of Code section 864(c)(2). Thus, the limited force of attraction rule of Code section 864(c)(3) is not incorporated into paragraph 2.

This Article does not contain a provision corresponding to paragraph 4 of Article 7 of the OECD Model. That paragraph provides that a Contracting State 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 inclusion of such a paragraph is unnecessary. Paragraphs 2 and 3 of Article 7 authorize the use of such approaches independently of paragraph 4 of Article 7 of the OECD Model because total profits methods are acceptable methods for determining the arm's length profits of an enterprise under Article 9. Any such approach, however, must be designed to approximate an arm's length result. Accordingly, it is understood that under paragraph 2 of the Convention, it is permissible to use methods other than separate accounting to estimate the arm's-length profits of a permanent establishment where it is necessary to do so for practical reasons, such as when the affairs of the permanent establishment are so closely bound up with those of the head office that it would be impossible to disentangle them on any strict basis of accounts.

Paragraph 3

This paragraph is in substance the same as paragraph 3 of Article 7 of the U.S. Model. Paragraph 3 provides that in determining the business profits of a permanent establishment, deductions shall be allowed for the expenses incurred for the purposes of the permanent establishment, ensuring that business profits will be taxed on a net basis. Whereas the U.S. Model explicitly states that deductions are not limited to expenses incurred exclusively for the purposes of the permanent establishment, in this treaty, like the OECD model, it is implicitly understood that there will be allowed a reasonable allocation to the permanent establishment of expenses incurred by the enterprise, whether those expenses were incurred for purposes of the enterprise as a whole, or they were incurred for the part of the enterprise that includes the permanent establishment, see paragraph 16 of the Commentaries to Article 7 of the OECD Model. Deductions are to be allowed regardless of which accounting unit of the enterprise books the expenses, so long as they are incurred for the purposes of the permanent establishment. For example, a portion of the interest expense recorded on the books of the home office in one State may be deducted by a permanent establishment in the other if properly allocable thereto.

The paragraph specifies that the expenses that may be considered to be incurred for the purposes of the permanent establishment are expenses for research and development, interest and other similar expenses, as well as a reasonable amount of executive and general administrative expenses. This rule permits (but does not require) each Contracting State to apply the type of expense allocation rules provided by U.S. law (such as in Treas. Reg. sections 1.861-8 and 1.882-5).

Paragraph 3 does not permit a deduction for expenses charged to a permanent establishment by another unit of the enterprise. Thus, a permanent establishment may not deduct a

royalty deemed paid to the head office. Similarly, a permanent establishment may not increase its business profits by the amount of any notional fees for ancillary services performed for another unit of the enterprise, but also should not receive a deduction for the expense of providing such services, since those expenses would be incurred for purposes of a business unit other than the permanent establishment.

The last sentence of the paragraph, which is neither in the U.S. Model nor in the OECD Model, allows each Contracting State, consistent with its law, to impose limitations on the deductions taken by the permanent establishment as long as the limitations are consistent with the concept of net income. This language was provided at the request of the Estonian delegation. The language allows the United States and Estonia to place limits on certain deductions, for example, entertainment expenses. However, it would not permit the Contracting States to deny a deduction for wages or interest expenses since such expenses are so fundamental that denial of deductions would be inconsistent with the concept of net income.

Paragraph 4

Paragraph 4 permits the tax authorities of a Contracting State to apply the provisions of internal law in determining tax liability in cases where the information available to the competent authority is not adequate to measure accurately the profits of a permanent establishment. The Internal Revenue Service would have this power even in the absence of such a specific provision. The determination of profits in such cases, based on the available information, must be done consistently with the principles of this Article, i.e., it must seek to reflect arm's length pricing and appropriate deductions of expenses.

Paragraph 5

Paragraph 5 provides that no business profits can be attributed to a permanent establishment merely because it purchases goods or merchandise for the enterprise of which it is a part. This paragraph is identical to paragraph 4 of the U.S. Model. This rule applies only to an office that performs functions for the enterprise in addition to purchasing. The income attribution issue does not arise if the sole activity of the permanent establishment is the purchase of goods or merchandise because such activity does not give rise to a permanent establishment under Article 5 (Permanent Establishment). A common situation in which paragraph 4 is relevant is one in which a permanent establishment purchases raw materials for the enterprise's manufacturing operation conducted outside the United States and sells the manufactured product. While business profits may be attributable to the permanent establishment with respect to its sales activities, no profits are attributable to it with respect to its purchasing activities.

Paragraph 6

This paragraph tracks paragraph 5 of Article 7 of the U.S. Model, providing that profits shall be determined by the same method each year, unless there is good reason to change the method used. This rule assures consistent tax treatment over time for permanent establishments.

It limits the ability of both the Contracting State and the enterprise to change accounting methods to be applied to the permanent establishment. It does not, however, restrict a Contracting State from imposing additional requirements, such as the rules under Code section 481, to prevent amounts from being duplicated or omitted following a change in accounting method.

Paragraph 7

The term "business profits" is broadly defined in paragraph 7 to mean income derived from any trade or business. Specific examples that are not meant to be comprehensive include profits from manufacturing, mercantile, fishing, transportation, communications or extractive activities. Business profits also include income from the furnishing of the personal services of other persons, but as the second sentence of paragraph 7 describes, business profits do not include compensation received by an individual for the performance of personal services, whether as an employee or in an independent capacity. Thus, a consulting firm resident in one State whose employees perform services in the other State through a permanent establishment may be taxed in that other State on a net basis under Article 7. The salaries of the employees, however, will be subject to the rules of Article 15 (Dependent Personal Services).

In accordance with this broad definition, 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 such instruments is, unless specifically covered in another article, dealt with under Article 21 (Other Income).

Unlike the U.S. Model and the OECD Model, income derived by an enterprise from the rental of tangible personal property is not included in this Article, but instead (with the exception of container leasing which is included in Article 21 (Other Income) and ship and aircraft leasing covered by Article 8 (Shipping and Air Transport)) is included in Article 12 (Royalties). .

Paragraph 8

Paragraph 8 coordinates the provisions of Article 7 and other provisions of the Convention. Under this paragraph, when business profits include items of income that are dealt with separately under other articles of the Convention, the provisions of those articles will, except when they specifically provide to the contrary, take precedence over the provisions of Article 7. For example, the taxation of dividends will be determined by the rules of Article 10 (Dividends), and not by Article 7, except where, as provided in paragraph 4 of Article 10, the dividend is attributable to a permanent establishment or fixed base. In the latter case the provisions of Articles 7 or 14 (Independent Personal Services) apply. Thus, an enterprise of one State deriving dividends from the other State may not rely on Article 7 to exempt those dividends from tax at source if they are

not attributable to a permanent establishment of the enterprise in the other State. By the same token, if the dividends are attributable to a permanent establishment in the other State, the dividends may be taxed on a net income basis at the source State's full corporate tax rate, rather than on a gross basis under Article 10 (Dividends).

As provided in Article 8 (Shipping and Air Transport), income derived from shipping and air transport activities in international traffic described in that Article is taxable only in the country of residence of the enterprise regardless of whether it is attributable to a permanent establishment situated in the source State.

Paragraph 9

Paragraph 9 incorporates into the Convention the rule of Code section 864(c)(6). Like the Code section on which it is based, paragraph 8 provides that any income or gain attributable to a permanent establishment or a fixed base during its existence is taxable in the Contracting State where the permanent establishment or fixed base is situated, even if the payment of that income or gain is deferred until after the permanent establishment or fixed base ceases to exist. This rule applies with respect to paragraphs 1 and 2 of Article 7 (Business Profits), paragraph 6 of Article 10 (Dividends), paragraph 5 of Articles 11 (Interest), paragraph 4 of 12 (Royalties), paragraph 3 of Article 13 (Gains), Article 14 (Independent Personal Services) and paragraph 2 of Article 21 (Other Income).

The effect of this rule can be illustrated by the following example. Assume a company that is a resident of Estonia and that maintains a permanent establishment in the United States winds up the permanent establishment's business and sells the permanent establishment's inventory and assets to a U.S. buyer at the end of year 1 in exchange for an interest-bearing installment obligation payable in full at the end of year 3. Despite the fact that Article 13's threshold requirement for U.S. taxation is not met in year 3 because the company has no permanent establishment in the United States, the United States may tax the deferred income payment recognized by the company in year 3.

Relation to Other Articles

This Article is subject to the saving clause of paragraph 4 of Article 1 (General Scope) of the Model. Thus, if a citizen of the United States who is a resident of Estonia under the treaty derives business profits from the United States that are not attributable to a permanent establishment in the United States, 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, notwithstanding the provision of paragraph 1 of this Article which would exempt the income from U.S. tax.

The benefits of this Article are also subject to Article 22 (Limitation on Benefits). Thus, an enterprise of Estonia that derives income effectively connected with a U.S. trade or business may

not claim the benefits of Article 7 unless the resident carrying on the enterprise qualifies for such benefits under Article 22.

ARTICLE 8 (SHIPPING AND AIR TRANSPORT)

This Article governs the taxation of profits from the operation of ships and aircraft in international traffic. The term "international traffic" is defined in subparagraph 1(g) of Article 3 (General Definitions). The taxation of gains from the alienation of ships, aircraft or containers is not dealt with in this Article but in paragraph 4 of Article 13 (Gains).

Paragraph 1

Paragraph 1 provides that profits derived by an enterprise of a Contracting State from the operation in international traffic of ships or aircraft are taxable only in that Contracting State. Because paragraph 8 of Article 7 (Business Profits) defers to Article 8 with respect to shipping income, such income derived by a resident of one of the Contracting States may not be taxed in the other State even if the enterprise has a permanent establishment in that other State. Thus, if a U.S. airline has a ticket office in the other State, that State may not tax the airline's profits attributable to that office under Article 7. Since entities engaged in international transportation activities normally will have many permanent establishments in a number of countries, the rule avoids difficulties that would be encountered in attributing income to multiple permanent establishments if the income were covered by Article 7 (Business Profits).

Paragraph 2

The income from the operation of ships or aircraft in international traffic that is exempt from tax under paragraph 1 is further defined in paragraph 2. In addition to income derived directly from the operation of ships and aircraft in international traffic, this definition also includes certain items of rental income that are closely related to those activities. First, income of an enterprise of a Contracting State from the rental of ships or aircraft on a full basis (*i.e.*, with crew) when such ships or aircraft are used in international traffic (*i.e.*, when operated by a resident of one of the contracting states) is income of the lessor from the operation of ships and aircraft in international traffic and, therefore, is exempt from tax in the other Contracting State under paragraph 1. Also, paragraph 2 encompasses income from the lease of ships or aircraft on a bareboat basis (*i.e.*, without crew), when the ships or aircraft are operated in international traffic (*i.e.*, when operated by a resident of one of the contracting states), and the income is incidental to other income of the lessor from the operation of ships or aircraft in international traffic. Thus, the coverage of Article 8 of the Convention is generally consistent with Article 8 of the OECD Model although narrower than the U.S. Model, which also covers rentals from bareboat leasing that are not incidental to the operation of ships or aircraft by the lessee. As discussed above, the classes of income derived from the rental of ships and air transport not included in this Article are included in Article 12 (Royalties) or Article 7 (Business Profits).

Paragraph 2 also clarifies, consistent with the Commentary to Article 8 of the OECD Model, that income earned by an enterprise from the inland transport of property or passengers within either Contracting State falls within Article 8 if the transport is undertaken as part of the international transport of property or passengers by the enterprise. Thus, if a U.S. shipping company contracts to carry property from the other State to a U.S. city and, as part of that contract, it transports the property by truck from its point of origin to an airport in the other State (or it contracts with a trucking company to carry the property to the airport) the income earned by the U.S. shipping company from the overland leg of the journey would be taxable only in the United States. Similarly, Article 8 also would apply to income from lighterage undertaken as part of the international transport of goods.

Finally, certain non-transport activities that are an integral part of the services performed by a transport company are understood to be covered in paragraph 1, though they are not specified in paragraph 2. These include, for example, the performance of some maintenance or catering services by one airline for another airline, if these services are incidental to the provision of those services by the airline for itself. Income earned by concessionaires, however, is not covered by Article 8. These interpretations of paragraph 1 also are consistent with the Commentary to Article 8 of the OECD Model.

Paragraph 3

Under this paragraph, profits of an enterprise of a Contracting State that is engaged in the operation of ships and aircraft derived from the use, maintenance or rental of containers (including equipment for their transport) that are used for the transport of goods in international traffic are exempt from tax in the other Contracting State. Thus, this paragraph applies only to income from the use, maintenance or rental of containers that is incidental to other income from international traffic. This differs from the U.S. Model in which both incidental and non-incidental income from the rental of containers is included in Article 8.

Paragraph 4

This paragraph clarifies that the provisions of paragraphs 1 and 3 also apply to profits derived by an enterprise of a Contracting State 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. For example, airlines from two countries may agree to share the transport of passengers between the two countries. They each will fly the same number of flights per week and share the revenues from that route equally, regardless of the number of passengers that each airline actually transports. Paragraph 4 makes clear that with respect to each carrier the income dealt with in the Article is that carrier's share of the total transport, not the income derived from the passengers actually carried by the airline. This paragraph corresponds to paragraph 4 of Article 8 of the OECD Model.

Relation to Other Articles

As with other benefits of the Convention, the benefit of exclusive residence country taxation under Article 8 is available to an enterprise only if it is entitled to benefits under Article 22 (Limitation on Benefits).

This Article also is subject to the saving clause of paragraph 4 of Article 1 (General Scope) of the Model. Thus, if a citizen of the United States who is a resident of Estonia derives profits from the operation of ships or 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. (This is an unlikely situation, however, because non-tax considerations (e.g., insurance) generally result in shipping activities being carried on in corporate form.)

ARTICLE 9 (ASSOCIATED ENTERPRISES)

This Article incorporates in the Convention the arm's-length principle reflected in the U.S. domestic transfer pricing provisions, particularly Code section 482. It provides that when related enterprises engage in a transaction on terms that are not arm's-length, the Contracting States may make appropriate adjustments to the taxable income and tax liability of such related enterprises to reflect what the income and tax of these enterprises with respect to the transaction would have been had there been an arm's-length relationship between them.

Paragraph 1

This paragraph is essentially the same as its counterpart in the OECD Model. It addresses the situation where an enterprise of a Contracting State is related to an enterprise of the other Contracting State, and there are arrangements or conditions imposed between the enterprises in their commercial or financial relations that are different from those that would have existed in the absence of the relationship. Under these circumstances, the Contracting States may adjust the income (or loss) of the enterprise to reflect what it would have been in the absence of such a relationship.

The paragraph identifies the relationships between enterprises that serve as a prerequisite to application of the Article. As the Commentary to the OECD Model makes clear, the necessary element in these relationships is effective control, which is also the standard for purposes of section 482. Thus, the Article applies if an enterprise of one State participates directly or indirectly in the management, control, or capital of the enterprise of the other State. Also, the Article applies if any third person or persons participate directly or indirectly in the management, control, or capital of enterprises of different States. For this purpose, all types of control are included, i.e., whether or not legally enforceable and however exercised or exercisable.

The fact that a transaction is entered into between such related enterprises does not, in and of itself, mean that a Contracting State may adjust the income (or loss) of one or both of the enterprises under the provisions of this Article. If the conditions of the transaction are consistent with those that would be made between independent persons, the income arising from that transaction should not be subject to adjustment under this Article.

Similarly, the fact that associated enterprises may have concluded arrangements, such as cost sharing arrangements or general services agreements, is not in itself an indication that the two enterprises have entered into a non-arm's-length transaction that should give rise to an adjustment under paragraph 1. Both related and unrelated parties enter into such arrangements (e.g., joint venturers may share some development costs). As with any other kind of transaction, when related parties enter into an arrangement, the specific arrangement must be examined to see whether or not it meets the arm's-length standard. In the event that it does not, an appropriate adjustment may be made, which may include modifying the terms of the agreement or recharacterizing the transaction to reflect its substance.

It is understood that the "commensurate with income" standard for determining appropriate transfer prices for intangibles, added to Code section 482 by the Tax Reform Act of 1986, was designed to operate consistently with the arm's-length standard. The implementation of this standard in the section 482 regulations is in accordance with the general principles of paragraph 1 of Article 9 of the Convention, as interpreted by the OECD Transfer Pricing Guidelines.

This Article also permits tax authorities to deal with thin capitalization issues. They may, in the context of Article 9, scrutinize more than the rate of interest charged on a loan between related persons. They also may examine the capital structure of an enterprise, whether a payment in respect of that loan should be treated as interest, and, if it is treated as interest, under what circumstances interest deductions should be allowed to the payor. Paragraph 2 of the Commentaries to Article 9 of the OECD Model, together with the U.S. observation set forth in paragraph 15 thereof, sets forth a similar understanding of the scope of Article 9 in the context of thin capitalization.

Paragraph 2

When a Contracting State has made an adjustment that is consistent with the provisions of paragraph 1, and the other Contracting State agrees that the adjustment was appropriate to reflect arm's-length conditions, that other Contracting State is obligated to make a correlative adjustment (sometimes referred to as a "corresponding adjustment") to the tax liability of the related person in that other Contracting State. This Convention, like the OECD Model but unlike the U.S. Model, does not specify that the other Contracting State must agree with the initial adjustment before it is obligated to make the correlative adjustment, but paragraph 6 to the Commentary on Article 9 of the OECD Model makes clear that the paragraph is to be interpreted that way.

As explained in the OECD Commentaries, Article 9 leaves the treatment of "secondary adjustments" to the laws of the Contracting States. When an adjustment under Article 9 has been made, one of the parties will have in its possession funds that it would not have had at arm's length. The question arises as to how to treat these funds. In the United States the general practice is to treat such funds as a dividend or contribution to capital, depending on the relationship between the parties. Under certain circumstances, the parties may be permitted to restore the funds to the party that would have the funds at arm's length, and to establish an account payable pending restoration of the funds. See, Rev. Proc. 99-32, 1999-34 IRB 296.

The Contracting State making a secondary adjustment will take the other provisions of the Convention, where relevant, into account. For example, if the effect of a secondary adjustment is to treat a U.S. corporation as having made a distribution of profits to its parent corporation in Estonia, the provisions of Article 10 (Dividends) will apply, and the United States may impose a 5 percent withholding tax on the dividend. Also, if under Article 23 (Relief From Double Taxation) Estonia generally gives a credit for taxes paid with respect to such dividends, it would also be required to do so in this case.

The competent authorities are authorized by paragraph 2 to consult, if necessary, to resolve any differences in the application of these provisions. For example, there may be a disagreement over whether an adjustment made by a Contracting State under paragraph 1 was appropriate.

If a correlative adjustment is made under paragraph 2, it is to be implemented notwithstanding any time limits or other procedural limitations in the law of the Contracting State making the adjustment. If a taxpayer has entered a closing agreement (or other written settlement) with the United States prior to bringing a case to the competent authorities, the U.S. competent authority will endeavor only to obtain a correlative adjustment from Estonia. See, Rev. Proc. 96-13, 1996-13 I.R.B. 31, Section 7.05.

Paragraph 3

Paragraph 3 preserves the right of Contracting States to apply internal law provisions relating to adjustments between related parties. They also reserve the right to make adjustments in cases involving tax evasion or fraud. Such adjustments -- the distribution, apportionment, or allocation of income, deductions, credits or allowances -- are permitted even if they are different from, or go beyond, those authorized by paragraph 1 of the Article, as long as they accord with the general principles of paragraph 1, *i.e.*, that the adjustment reflects what would have transpired had the related parties been acting at arm's length. For example, while paragraph 1 explicitly allows adjustments of deductions in computing taxable income, it does not deal with adjustments to tax credits. It does not, however, preclude such adjustments if they can be made under internal law. The provision does not grant authority not otherwise present under internal law. The OECD Model reaches the same result. See paragraph 4 of the Commentaries to Article 9.

Relationship to Other Articles

The saving clause of paragraph 4 of Article 1 (General Scope) does not apply to paragraph 2 of Article 9 by virtue of the exceptions to the saving clause in paragraph 5(a) of Article 1. Thus, even if the statute of limitations has run, a refund of tax can be made in order to implement a correlative adjustment. Statutory or procedural limitations, however, cannot be overridden to impose additional tax, because paragraph 2 of Article 1 provides that the Convention cannot restrict any statutory benefit.

ARTICLE 10 (DIVIDENDS)

Article 10 provides rules for the taxation of dividends paid by a resident of one Contracting State to a beneficial owner that is a resident of the other Contracting State. The article provides for full residence country taxation of such dividends and a limited source-State right to tax. Article 10 also provides rules for the imposition of a tax on branch profits by the State of source. Finally, the article prohibits a State from imposing a tax on dividends paid by companies resident in the other Contracting State, except in specific circumstances.

Paragraph 1

The right of the country of residence of the beneficial owner of a dividend to tax dividends arising in the source country is preserved by paragraph 1, which permits a Contracting State to tax its residents on dividends beneficially owned by them and paid to them by a resident of the other Contracting State. For dividends from any other source paid to a resident, Article 21 (Other Income) grants the residence country exclusive taxing jurisdiction (other than for dividends attributable to a permanent establishment or fixed base in the other State).

Paragraph 2

The State of source may also tax dividends beneficially owned by a resident of the other State, subject to the limitations in paragraph 2. Generally, the source State's tax is limited to 15 percent of the gross amount of the dividend paid. If, however, the beneficial owner of the dividends is a company resident in the other State that holds at least 10 percent of the voting shares of the company paying the dividend, then the source State's tax is limited to 5 percent of the gross amount of the dividend. Indirect ownership of voting shares (through tiers of corporations) and direct ownership of non-voting shares are not taken into account for purposes of determining eligibility for the 5 percent direct dividend rate. Shares are considered voting shares if they provide the power to elect, appoint or replace any person vested with the powers ordinarily exercised by the board of directors of a U.S. corporation. The Convention does not require that the 10-percent voting interest be held for a minimum period prior to the dividend payment date.

The benefits of paragraph 2 may be granted at the time of payment by means of reduced withholding at source. It also is consistent with the paragraph for tax to be withheld at the time of payment at full statutory rates, and the treaty benefit to be granted by means of a subsequent refund so long as such procedures are applied in a reasonable manner..

Paragraph 2 does not affect the taxation of the profits out of which the dividends are paid. The taxation by a Contracting State of the income of its resident companies is governed by the internal law of the Contracting State, subject to the provisions of paragraph 5 of Article 24 (Nondiscrimination).

The term "beneficial owner" is not defined in the Convention, and is, therefore, defined as under the internal law of the country imposing tax (i.e., the source country). The beneficial owner of the dividend for purposes of Article 10 is the person to which the dividend income is attributable for tax purposes under the laws of the source State. Thus, if a dividend paid by a corporation that is a resident of one of the States (as determined under Article 4 (Resident)) is received by a nominee or agent that is a resident of the other State on behalf of a person that is not a resident of that other State, the dividend is not entitled to the benefits of this Article. However, a dividend received by a nominee on behalf of a resident of that other State would be entitled to benefits. These limitations are confirmed by paragraph 12 of the OECD Commentaries to Article 10. See also, paragraph 24 of the OECD Commentaries to Article 1 (General Scope).

Companies holding shares through fiscally transparent entities such as partnerships are considered for purposes of this paragraph to hold their proportionate interest in the shares held by the intermediate entity. As a result, companies holding shares through such entities may be able to claim the benefits of subparagraph (a) under certain circumstances. The lower rate applies when the company's proportionate share of the shares held by the intermediate entity meets the 10 percent voting stock threshold. Whether this ownership threshold is satisfied may be difficult to determine and often will require an analysis of the partnership or trust agreement.

The flush text in paragraph 2 provides rules that modify the maximum rates of tax at source when a RIC or REIT paying the dividend is a U.S. person. The first sentence of the flush text denies the lower direct investment withholding rate of 5% in paragraph 2(a) for dividends paid by a U.S. Regulated Investment Company (RIC) or a U.S. Real Estate Investment Trust (REIT). The second sentence allows the benefit of the lower 15% withholding rate in paragraph 2(b) for dividends paid by a U.S. RIC. The third sentence of the flush text denies the benefits of both subparagraphs (a) and (b) of paragraph 2 to dividends paid by U.S. REITs in certain circumstances, allowing them to be taxed at the U.S. statutory rate (30 percent). Under this paragraph the United States limits the source tax on dividends paid by a REIT to the 15 percent rate when the beneficial owner of the dividend is an individual resident of Estonia that owns a less than 10 percent interest in the REIT

The denial of the 5 percent withholding rate at source to all RIC and REIT shareholders, and the denial of the 15 percent rate to all but small individual shareholders of REITs is intended

to prevent the use of these entities to gain unjustifiable source taxation benefits for certain shareholders resident in Estonia. For example, a corporation resident in Estonia 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 shares 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 in paragraph 2, use of the RIC could transform portfolio dividends, taxable in the United States under the Convention at 15 percent, into direct investment dividends taxable only at 5 percent.

Similarly, a resident of Estonia directly holding U.S. real property would pay U.S. tax either at a 30 percent rate on the gross income or at graduated rates on the net income. As in the preceding example, by placing the real property in a REIT, the investor could transform real estate income into dividend income, taxable at the rates provided in Article 10, significantly reducing the U.S. tax that otherwise would be imposed. To prevent this circumvention of U.S. rules applicable to real property, most REIT shareholders are subject to 30 percent tax at source. However, since a relatively small individual investor who might be subject to a U.S. tax of 15 percent of the net income even if he earned the real estate income directly, individuals who hold less than a 10 percent interest in the REIT remain taxable at source at a 15 percent rate.

Paragraph 3

Paragraph 3 defines the term dividends for purposes of Article 10 broadly and flexibly. The definition is intended to cover all arrangements that yield a return on an equity investment in a corporation as determined under the tax law of the state of source, as well as arrangements that might be developed in the future.

The term dividends includes income from shares or other rights that are not debt-claims and that participate in profits. It also includes income derived from other corporate rights that is subjected to the same taxation treatment as income from shares by the domestic taxation laws of the Contracting State of which the company making the distribution is a resident. Thus, a constructive dividend that results from a non-arm's length transaction between a corporation and a related party is a dividend. The term "dividends" further specifically includes income from arrangements (including instruments denominated as debt claims) that carry the right to participate in profits, or that are determined by reference to profits, to the extent the income from the arrangement is characterized as a dividend under the law of the Contracting State in which the income arises.

In general, this definition has the effect of deferring to the source State's characterization of income as a dividend. It ensures, for example, that a payment denominated as interest that is made by a thinly capitalized corporation may be treated as a dividend to the extent that the debt is recharacterized as equity under the laws of the source State. In the case of the United States, the term "dividend" also includes amounts treated as a dividend under U.S. law upon the sale or

redemption of shares or upon a transfer of shares in a reorganization. See, e.g., Rev. Rul. 92-85, 1992-40 IRB 10 (sale of foreign subsidiary's stock to U.S. sister company is a deemed dividend to extent of subsidiary's and sister's earnings and profits). Further, a distribution from a U.S. publicly traded limited partnership, which is taxed as a corporation under U.S. law, is a dividend for purposes of Article 10. However, a distribution by a limited liability company ("LLC") is not recognized by the United States as a dividend and, therefore, is not a dividend for purposes of Article 10, provided the LLC is not characterized as an association taxable as a corporation under U.S. law.

Paragraph 4

Paragraph 4 excludes from the general source country limitations under paragraph 2 dividends paid with respect to holdings that form part of the business property of a permanent establishment or a fixed base. Such dividends will be taxed on a net basis using the rates and rules of taxation generally applicable to residents of the State in which the permanent establishment or fixed base is located, as modified by the Convention. An example of dividends paid with respect to the business property of a permanent establishment would be dividends derived by a dealer in stock or securities from stock or securities that the dealer held for sale to customers. In the case of a permanent establishment or fixed base that once existed in the State but that no longer exists, the provisions of paragraph 5 also apply, by virtue of paragraph 9 of Article 7 (Business Profits), to dividends that would be attributable to such a permanent establishment or fixed base if it did exist in the year of payment or accrual. See the Technical Explanation of paragraph 9 of Article 7.

Paragraph 5

Paragraph 5 permits a State to impose a branch profits tax on a company resident in the other State. The tax is in addition to other taxes permitted by the Convention. The term company is defined in paragraph 1(d) of Article 3 (General Definitions). Estonia currently has no branch profits tax.

A State may impose a branch profits tax on a company if the company has income attributable to a permanent establishment in that State, derives income from real property in that State that is taxed on a net basis under Article 6, or realizes gains taxable in that State under paragraph 1 of Article 13. The tax, however, is limited to the aforementioned items of income that are included in the "dividend equivalent amount."

Paragraph 5 permits the United States generally to impose its branch profits tax on a corporation resident in Estonia to the extent of the corporation's (i) business profits that are attributable to a permanent establishment in the United States (ii) income that is subject to taxation on a net basis because the corporation has elected under section 882(d) of the Code to treat income from real property not otherwise taxed on a net basis as effectively connected income and (iii) gain from the disposition of a United States Real Property Interest, other than an

interest in a United States Real Property Holding Corporation. The United States may not impose its branch profits tax on the business profits of a corporation resident in Estonia that are effectively connected with a U.S. trade or business but that are not attributable to a permanent establishment and are not otherwise subject to U.S. taxation under Article 6 or paragraph 1 of Article 13.

The term "dividend equivalent amount" used in paragraph 5 has the same meaning that it has under section 884 of the Code, as amended from time to time, provided the amendments are consistent with the purpose of the branch profits tax. Generally, the dividend equivalent amount for a particular year is the income described above that is included in the corporation's effectively connected earnings and profits for that year, after payment of the corporate tax under Articles 6, 7 or 13, reduced for any increase in the branch's U.S. net equity during the year or increased for any reduction in its U.S. net equity during the year. U.S. net equity is U.S. assets less U.S. liabilities. See, Treas. Reg. section 1.884-1. The dividend equivalent amount for any year approximates the dividend that a U.S. branch office would have paid during the year if the branch had been operated as a separate U.S. subsidiary company. In the case that Estonia also enacts a branch profits tax, the base of its tax is limited to an amount that is analogous to the dividend equivalent amount.

The branch profits tax permitted by paragraph 5 shall not exceed five percent of the portion of the profits of the company subject to tax in the other State. In the United States this is the dividend equivalent amount of such profits and in Estonia this would be an amount analogous to the dividend equivalent amount. The five percent rate was chosen to be consistent with the direct investment dividend withholding rate.

Paragraph 6

A State's right to tax dividends paid by a company that is a resident of the other State is restricted by paragraph 7 to cases in which the dividends are paid to a resident of that State or are attributable to a permanent establishment or fixed base in that State. Thus, a State may not impose a "secondary" withholding tax on dividends paid by a nonresident company out of earnings and profits from that State. In the case of the United States, paragraph 7, therefore, overrides the taxes imposed by sections 871 and 882(a) on dividends paid by foreign corporations that have a U.S. source under section 861(a)(2)(B).

The paragraph does not restrict a State's right to tax its resident shareholders on undistributed earnings of a corporation resident in the other State. Thus, the U.S. authority to impose the foreign personal holding company tax, its taxes on subpart F income and on an increase in earnings invested in U.S. property, and its tax on income of a Passive Foreign Investment Company that is a Qualified Electing Fund is in no way restricted by this provision.

Unlike the U.S. Model Convention and the OECD Model Convention, this Convention does not restrict a State's right to impose corporate level taxes on undistributed profits. Thus, the

United States can apply the accumulated earnings tax and the personal holding company tax, which are not taxes covered in Article 2 (Taxes Covered), to undistributed earnings.

Relation to Other Articles

Notwithstanding the foregoing limitations on source country taxation of dividends, the saving clause of paragraph 4 of Article 1 permits the United States to tax dividends received by its residents and citizens as if the Convention had not come into effect.

The benefits of this Article are also subject to the provisions of Article 22 (Limitation on Benefits). Thus, if a resident of the other Contracting State is the beneficial owner of dividends paid by a U.S. corporation, the shareholder must qualify for treaty benefits under at least one of the tests of Article 22 in order to receive the benefits of this Article.

ARTICLE 11 (INTEREST)

Article 11 governs the taxation of interest. Generally, the Article provides for full residence country taxation of interest and for a limited source State right to tax such income.

Paragraph 1

The right of a beneficial owner's country of residence to tax interest arising in the other Contracting State is preserved by paragraph 1. For interest from any other source paid to a resident, Article 21 (Other Income) grants the residence country exclusive taxing jurisdiction (other than for interest attributable to a permanent establishment or fixed base in the other State).

Paragraph 2

Paragraph 2 grants to the source State the right to tax interest payments beneficially owned by a resident of the other Contracting State. The general rate of source country tax applicable to interest payments under paragraph 2 is limited to 10 percent. Under the provisions of paragraph 3 the rate is modified and certain classes of interest payments are exempt from source country tax.

The term "beneficial owner" is not defined in the Convention, and is, therefore, defined as under the internal law of the country imposing tax (i.e., the source country). The beneficial owner of interest for purposes of Article 11 is the person to which the interest income is attributable for tax purposes under the laws of the source State. Thus, if interest arising in one of the States is received by a nominee or agent that is a resident of the other State on behalf of a person that is not a resident of that other State, the interest is not entitled to the benefits of this Article. However, interest received by a nominee on behalf of a resident of that other State would be entitled to benefits. These limitations are confirmed by paragraph 8 of the OECD Commentary on Article 11. See also, paragraph 24 of the OECD Commentaries to Article 1 (General Scope).

Paragraph 3

Paragraphs 3a) and 3b) specify certain categories of interest that are exempt from source State taxation. Paragraph 3a) exempts interest arising in one Contracting State paid to the Government of the other Contracting State, its political subdivisions and local authorities or to the central bank of the other Contracting State (i.e., The Central Bank of Estonia or any Federal Reserve Bank of the United States). Paragraph 3a) also exempts interest arising in connection with a debt obligation that is guaranteed or insured by the other Contracting State, its political subdivisions and local authorities, or institutions, such as the U.S. Export-Import Bank and the Overseas Private Investment Corporation. Paragraph 3b) exempts interest arising in a Contracting State that is paid with respect to an indebtedness arising as a consequence of the sale on credit of any merchandise or equipment by an enterprise in one Contracting State to an enterprise in the other Contracting State, except where the sale on credit is between related persons.

Paragraph 3c) reserves the right of the United States to tax an excess inclusion of a residual holder of a Real Estate Mortgage Investment Conduit (REMIC) in accordance with U.S. domestic law, that is, at the statutory withholding tax of 30 percent. This is consistent with the policy of Code sections 860E(e) and 860G(b) that excess inclusions with respect to a real estate mortgage investment conduit (REMIC) should bear full U.S. tax in all cases. Without a full tax at source, foreign purchasers of residual interests would have a competitive advantage over U.S. purchasers at the time these interests are initially offered. Also, absent this rule the U.S. fisc would suffer a revenue loss with respect to mortgages held in a REMIC because of opportunities for tax avoidance created by differences in the timing of taxable and economic income produced by these interests.

Paragraph 3d) deals with so-called "contingent interest". Under this provision interest arising in one of the Contracting States 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 to a related person, also may be taxed in the Contracting State in which it arises, and according to the laws of that State. However, if the beneficial owner is a resident of the other Contracting State, the gross amount of the interest may be taxed at a rate not exceeding the 15% rate prescribed in subparagraph b) of paragraph 2 of Article 10 (Dividends).

Paragraph 4

The term "interest" as used in Article 11 is defined in paragraph 4 to include, *inter alia*, income from debt claims of every kind, whether or not secured by a mortgage. Penalty charges for late payment are excluded from the definition of interest. Interest that is paid or accrued subject to a contingency is within the ambit of Article 11. This includes income from a debt

obligation carrying the right to participate in profits. The term does not, however, include amounts that are treated as dividends under Article 10 (Dividends).

The term interest also includes amounts subject to the same tax treatment as income from money lent under the law of the State in which the income arises. Thus, for purposes of the Convention, amounts that the United States will treat as interest include (i) the difference between the issue price and the stated redemption price at maturity of a debt instrument, i.e., original issue discount (OID), which may be wholly or partially realized on the disposition of a debt instrument (section 1273), (ii) amounts that are imputed interest on a deferred sales contract (section 483), (iii) amounts treated as interest or OID under the stripped bond rules (section 1286), (iv) amounts treated as original issue discount under the below-market interest rate rules (section 7872), (v) a partner's distributive share of a partnership's interest income (section 702), (vi) the interest portion of periodic payments made under a "finance lease" or similar contractual arrangement that in substance is a borrowing by the nominal lessee to finance the acquisition of property, (vii) amounts included in the income of a holder of a residual interest in a REMIC (section 860E), because these amounts generally are subject to the same taxation treatment as interest under U.S. tax law, and (viii) embedded interest with respect to notional principal contracts.

Paragraph 5

Paragraph 5 provides an exception to the taxing rules of paragraphs 1 and 2 in cases where the beneficial owner of the interest carries on business through a permanent establishment in the State of source or performs independent personal services from a fixed base situated in that State and the interest is attributable to that permanent establishment or fixed base. In such cases the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services) will apply and the State of source will retain the right to impose tax on such interest income on a net basis.

In the case of a permanent establishment or fixed base that once existed in the State but that no longer exists, the provisions of paragraph 5 also apply, by virtue of paragraph 9 of Article 7 (Business Profits), to interest that would be attributable to such a permanent establishment or fixed base if it did exist in the year of payment or accrual. (See the Technical Explanation of paragraph 9 of Article 7.)

Paragraph 6

Paragraph 6 contains the source rule for interest. This rule provides that the source of an interest payment generally is the State of residence of the payor, unless the interest is borne by a permanent establishment or fixed base in the other State, in which case the source is assigned to that other State.

Paragraph 7

Paragraph 7 provides that in cases involving special relationships between persons, Article 11 applies only to that portion of the total interest payments between those persons that would have been made absent such special relationships (*i.e.*, an arm's-length interest payment). Any excess amount of interest paid remains taxable according to the laws of the United States and Estonia, respectively, with due regard to the other provisions of the Convention. Thus, if the excess amount would be treated under the source country's law as a distribution of profits by a corporation, such amount could be taxed as a dividend rather than as interest, but the tax would be subject, if appropriate, to the rate limitations of paragraph 2 of Article 10 (Dividends).

The term "special relationship" is not defined in the Convention. In applying this paragraph the United States considers the term to include the relationships described in Article 9 (Associated Enterprises), which in turn correspond to the definition of "control" for purposes of section 482 of the Code.

This paragraph does not address cases where, owing to a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest is less than an arm's-length amount. In those cases a transaction may be characterized to reflect its substance and interest may be imputed consistent with the definition of interest in paragraph 4. Consistent with Article 9 (Associated Enterprises) the United States would apply section 482 or 7872 of the Code to determine the amount of imputed interest in those cases.

Paragraph 8

Paragraph 8 permits the United States to impose its branch level interest tax on a corporation resident in Estonia. The base of this tax is the excess, if any, of the interest deductible in the United States in computing the profits of the corporation that are subject to tax in the United States and either attributable to a permanent establishment in the United States or subject to tax in the United States under Article 6 or Article 13 of this Convention over the interest paid by or from the permanent establishment or trade or business in the United States.

Relation to Other Articles

Notwithstanding the limitations on source country taxation of interest contained in this Article, the saving clause of paragraph 4 of Article 1 (General Scope) permits the United States to tax interest received by its residents and citizens as if the Convention had not come into effect.

As with any other benefit of the Convention, a resident of one of the States claiming the benefit of this Article must be entitled to the benefit under the provisions of Article 22 (Limitation on Benefits).

ARTICLE 12 (ROYALTIES)

Article 12 provides rules for source and residence country taxation of royalties. Generally, the Article provides for full residence country taxation of royalties and for a limited source State right to tax such income.

Paragraph 1

The right of a beneficial owner's country of residence to tax royalties arising in the other Contracting State is preserved by paragraph 1. For royalties from any other source paid to a resident, Article 21 (Other Income) grants the residence country exclusive taxing jurisdiction (other than for royalties attributable to a permanent establishment or fixed base in the other State).

Paragraph 2

Paragraph 2 grants to the source State the right to tax royalty payments but limits the rate of source State tax if the royalties are beneficially owned by a resident of the other Contracting State. The maximum rate of tax allowed by the source State varies depending upon the nature of the payment. The maximum rate of source country tax is 5 percent if the royalty payment is received for the rental of industrial, commercial or scientific equipment. All other royalties are subject to tax at a maximum rate of 10 percent under subparagraph 2(b).

The term "beneficial owner" is not defined in the Convention, and is, therefore, defined as under the internal law of the country imposing tax (i.e, the source country). The beneficial owner of royalties for purposes of Article 12 is the person to which the royalty income is attributable for tax purposes under the laws of the source State. Thus, if royalties arising in one of the States is received by a nominee or agent that is a resident of the other State on behalf of a person that is not a resident of that other State, the royalties are not entitled to the benefits of this Article. However, royalties received by a nominee on behalf of a resident of that other State would be entitled to benefits. These limitations are confirmed by paragraph 4 of the OECD Commentaries to Article 12. See also, paragraph 24 of the OECD Commentaries to Article 1 (General Scope).

Paragraph 3

Paragraph 3 defines the term "royalties" for purposes of the Article. The term means payments of any kind received as a consideration for the use of, or the right to use, any copyright of a literary, artistic, or scientific work including computer software, cinematographic films and films or tapes and other means of image or sound reproduction for radio and television broadcasting; for the use of, or the right to use, any patent, trademark, design or model, plan, secret formula or process or other like right or property; or for information concerning industrial, commercial, or scientific experience; for the use of, or the right to use information concerning industrial, commercial or scientific experience. In deviation from the OECD Model and from most U.S. treaties, "royalties" also includes payments of any kind received as a consideration for the use of, or the right to use industrial, commercial or scientific equipment. As noted above in the explanation to Paragraph 2, such royalties are taxed at the lower 5 percent rate.

The term "royalties" also includes gain derived from the alienation of any right or property that would give rise to royalties, to the extent the gain is contingent on the productivity, use, or further alienation thereof. As a consequence, such amounts may be taxed in accordance with this Article. Gains that are not so contingent are dealt with under Article 13 (Gains).

The term royalties is defined in the Convention and therefore is generally independent of domestic law. Certain terms used in the definition are not defined in the Convention, but these may be defined under domestic tax law. For example, the term "secret process or formulas" is found in the Code, and its meaning has been elaborated in the context of sections 351 and 367. See Rev. Rul. 55-17, 1955-1 C.B. 388; Rev. Rul. 64-56, 1964-1 C.B. 133; Rev. Proc. 69-19, 1969-2 C.B. 301.

Consideration for the use or right to use cinematographic films, or works on film, tape, or other means of reproduction in radio or television broadcasting is specifically included in the definition of royalties. The reference to "other means of reproduction" as it relates to cinematographic films, or works on file and tape makes clear that future technological advances in the field of radio and television broadcasting will not affect the inclusion of payments relating to the use of such means of reproduction within the definition of royalties.

If an artist who is resident in one Contracting State records a performance in the other Contracting State, retains a copyrighted interest in a recording, and receives payments for the right to use the recording based on the sale or public playing of the recording, then the right of such other Contracting State to tax those payments is governed by Article 12. See Boulez v. Commissioner, 83 T.C. 584 (1984), aff'd, 810 F.2d 209 (D.C. Cir. 1986).

Computer software generally is protected by copyright laws around the world. Under the Convention, consideration received for the use, or the right to use, computer software is treated either as royalties or as business profits, depending on the facts and circumstances of the transaction giving rise to the payment.

The primary factor in determining whether consideration received for the use, or the right to use, computer software is treated as royalties or as business profits, is the nature of the rights transferred. See, Treas. Reg. section 1.861-18. The fact that the transaction is characterized as a license for copyright law purposes is not dispositive. For example, as was discussed and understood among the negotiators, a typical retail sale of "shrink wrap" software generally will not be considered to give rise to royalty income, even though for copyright law purposes it may be characterized as a license.

The means by which the computer software is transferred are not relevant for purposes of the analysis. Consequently, if software is electronically transferred but the rights obtained by the transferee are substantially equivalent to rights in a program copy, the payment will be considered business profits.

The term "industrial, commercial, or scientific experience" (sometimes referred to as "know-how") has the meaning ascribed to it in paragraph 11 of the Commentary to Article 12 of the OECD Model Convention. Consistent with that meaning, the term may include information that is ancillary to a right otherwise giving rise to royalties, such as a patent or secret process.

Know-how also may include, in limited cases, technical information that is conveyed through technical or consultancy services. It does not include general educational training of the user's employees, nor does it include information developed especially for the user, for example, a technical plan or design developed according to the user's specifications. Thus, as provided in paragraph 11 of the Commentaries to Article 12 of the OECD Model, the term "royalties" does not include payments received as consideration for after-sales service, for services rendered by a seller to a purchaser under a guarantee, or for pure technical assistance.

The term "royalties" also does not include payments for professional services (such as architectural, engineering, legal, managerial, medical, software development services). For example, income from the design of a refinery by an engineer (even if the engineer employed know-how in the process of rendering the design) or the production of a legal brief by a lawyer is not income from the transfer of know-how taxable under Article 12, but is income from services taxable under either Article 14 (Independent Personal Services) or Article 15 (Dependent Personal Services). Professional services may be embodied in property that gives rise to royalties, however. Thus, if a professional contracts to develop patentable property and retains rights in the resulting property under the development contract, subsequent license payments made for those rights would be royalties.

Paragraph 4

This paragraph provides an exception to the rules of paragraph 2 that limit the rate of source country taxation of royalties. This paragraph applies in cases where the beneficial owner of the royalties carries on business through a permanent establishment in the state of source or performs independent personal services from a fixed base situated in that state and the royalties are attributable to that permanent establishment or fixed base. In such cases the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services) will apply.

The provisions of paragraph 9 of Article 7 (Business Profits) apply to this paragraph. For example, royalty income that is attributable to a permanent establishment or a fixed base and that accrues during the existence of the permanent establishment or fixed base, but is received after the permanent establishment or fixed base no longer exists, remains taxable under the provisions of Articles 7 (Business Profits) or 14 (Independent Personal Services), respectively, and not under this Article.

Paragraph 5

Paragraph 5 provides that in cases involving special relationships between the payor and beneficial owner of royalties, Article 12 applies only to the extent the royalties would have been

paid absent such special relationships (*i.e.*, an arm's-length royalty). Any excess amount of royalties paid remains taxable according to the laws of the two Contracting States with due regard to the other provisions of the Convention. If, for example, the excess amount is treated as a distribution of corporate profits under domestic law, such excess amount will be taxed as a dividend rather than as royalties, but the tax imposed on the dividend payment will be subject to the rate limitations of paragraph 2 of Article 10 (Dividends).

Paragraph 6

Subparagraphs 6(a) and 6(b) provide rules for determining the source of royalty payments. Subparagraph 6(c) provides rules for determining the source of payments received as consideration for the use of containers.

Under subparagraph 6(a), royalties are generally deemed to arise in a Contracting State if paid by a resident of that State. However, if the obligation to pay the royalties was incurred in connection with a permanent establishment or a fixed base in one of the Contracting States, and the royalties are borne by that permanent establishment or fixed base, the royalties are deemed to arise in that State, regardless of whether the payor is resident in one of the Contracting States. In general, royalties are considered borne by a permanent establishment or fixed base if deductible in computing the taxable income of that permanent establishment or fixed base. Under subparagraph 6(b), if royalties are neither paid by a resident of one of the Contracting States nor borne by a permanent establishment or fixed base in either State, so that they are not covered by subparagraph 6(a), but they relate to the use of a right or property in one of the Contracting States, they will be deemed to arise in the State where the right or property is used. For example, if a Estonian resident were to grant franchise rights to a resident of Mexico for use in the United States, the royalty paid by the Mexican resident to the Estonian resident for those rights would be U.S. source income under this Article, subject to U.S. withholding at the 10 percent rate provided in paragraph 2.

The rules of this Article differ from those provided under U.S. domestic law. Under U.S. domestic law, a royalty is considered to be from U.S. sources if it is paid for the use of, or the privilege of using, an intangible within the United States; the residence of the payor is irrelevant. If paid to a nonresident alien individual or other foreign person, a U.S. source royalty is generally subject to withholding tax at a rate of 30 percent under U.S. domestic law. By reason of paragraph 2 of Article 1 (Personal Scope), an Estonian resident would be permitted to apply the rules of U.S. domestic law to its royalty income if those rules produced a more favorable result in its case than those of this Article. However, under a basic principle of tax treaty interpretation, the prohibition against so-called "cherry-picking," the Estonian resident would be precluded from claiming selected benefits under the Convention (e.g., the tax rates only) and other benefits under U.S. domestic law (e.g., the source rules only) with respect to its royalties. See, e.g., Rev. Rul. 84-17, 1984-1 C.B. 308. For example, if an Estonian company granted franchise rights to a resident of the United States for use 50 percent in the United States and 50 percent in Mexico, the Convention would permit the Estonian company to treat all of its royalty income from that single

transaction as U.S. source income entitled to the withholding tax reduction under paragraph 2. U.S. domestic law would permit the Estonian company to treat 50 percent of its royalty income as U.S. source income subject to a 30 percent withholding tax and the other 50 percent as foreign source income exempt from U.S. tax. The Estonian company could choose to apply either the provisions of U.S. domestic law or the provisions of the Convention to the transaction, but would not be permitted to claim both the U.S. domestic law exemption for 50 percent of the income and the Convention's reduced withholding rate for the remainder of the income.

Subparagraph 6 c) provides a rule that applies only to payments received as consideration for the use of containers (including trailers, barges, and related equipment for the transport of containers) used in transportation of passengers or property (other than transportation solely between places within a Contracting State) not dealt with in Article 8 (Shipping and Air Transport). Such payments not included in Article 8 are those received as consideration for the non-incidentally rental of containers. Such payments are deemed to arise in neither Contracting State, and thus, do not fall under the taxing rules of Article 12, since as noted in paragraph 1 of Article 12, Article 12 only applies to payments of royalties that arise in a Contracting State. Non-incidentally container leasing is not included as Royalties in Article 12 nor as profits from the operation of ships and aircraft in international traffic in Article 8 and thus falls under Other Income in Article 22. Other income beneficially owned by a resident of a Contracting State is only taxable by that resident's State. Thus, non-incidentally container leasing is taxed in the same way in both this Convention and the U.S. model.

Relation to Other Articles

Notwithstanding the foregoing limitations on source country taxation of royalties, the saving clause of paragraph 4 of Article 1 (General Scope) permits the United States to tax its residents and citizens as if the Convention had not come into force.

As with other benefits of the Convention, the benefits of reduced source state taxation of royalties under paragraph 2 of Article 12 are available to a resident of the other State only if that resident is entitled to those benefits under Article 21 (Limitation on Benefits).

ARTICLE 13 (CAPITAL GAINS)

Article 13 assigns either primary or exclusive taxing jurisdiction over gains from the alienation of property to the State of residence or the State of source and defines the terms necessary to apply the Article.

Paragraph 1

Paragraph 1 of Article 13 preserves the non-exclusive right of the State of source to tax gains attributable to the alienation of real property situated in that State. The paragraph therefore permits the United States to apply section 897 of the Code to tax gains derived by a resident of

Estonia that are attributable to the alienation of real property situated in the United States (as defined in paragraph 2). Gains attributable to the alienation of real property include gain from any other property that is treated as a real property interest within the meaning of paragraph 2. Although Estonia uses the term "immovable property", it is to be understood from the parenthetical use of the term "real" that the two terms are synonymous.

Paragraph 2

This paragraph defines the term "immovable (real) property situated in the other Contracting State," gains from which are subject to the rule of paragraph 1. The term includes real property referred to in Article 6 (i.e., an interest in the real property itself), and a "United States real property interest" when the United States is the other Contracting State under paragraph 1. It also includes shares of stock of a company the property of which consists at least 50 percent of immovable (real) property situated in that other State, and an interest in a partnership, trust or estate to the extent that its assets consist of immovable (real) property situated in that other State. The OECD Model does not refer to real property interests other than the real property itself, and the United States has entered a reservation on this point with respect to the OECD Model, reserving the right to apply its tax under FIRPTA to all real estate gains encompassed by that provision.

Under section 897(c) of the Code the term "United States real property interest" includes shares in a U.S. corporation that owns sufficient U.S. real property interests to satisfy an asset-ratio test on certain testing dates. The term also includes certain foreign corporations that have elected to be treated as U.S. corporations for this purpose. Section 897(i). In applying paragraph 1 the United States will look through distributions made by a REIT. Accordingly, distributions made by a REIT are taxable under paragraph 1 of Article 13 (not under Article 10 (Dividends)) when they are attributable to gains derived from the alienation of real property.

Paragraph 3

Paragraph 3 of Article 13 deals with the taxation of certain gains from the alienation of personal (movable) property forming part of the business property of a permanent establishment that an enterprise of a Contracting State has in the other Contracting State or of personal property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services. This also includes gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base. Such gains may be taxed in the State in which the permanent establishment or fixed base is located. Although Estonia uses the term "movable property", and the United States uses the term "personal property" it is understood that the two terms are synonymous.

A resident of Estonia 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. Rev. Rul. 91-32, 1991-1 C.B. 107. Further, under paragraph 3, the United States generally may tax a partner's distributive share of income realized by a partnership on the disposition of movable property forming part of the business property of the partnership in the United States.

Paragraph 4

This paragraph limits the taxing jurisdiction of the state of source with respect to gains derived by an enterprise of a Contracting State that operates ships or aircraft in international traffic from the alienation of ships, aircraft, or containers operated in international traffic or movable property pertaining to the operation of such ships, aircraft, or containers. Under paragraph 4, when such income is derived by an enterprise of a Contracting State it is taxable only in that Contracting State. Notwithstanding paragraph 3, these rules apply even if the income is attributable to a permanent establishment maintained by the enterprise in the other Contracting State.

However, if the gains from alienation of ships, aircraft or containers is not derived by an enterprise of a Contracting State that operates ships or aircraft in international traffic, then such gains are taxable in the source state as well. An example of such gains taxable in the source state is income derived from the alienation of ships, aircraft or containers owned by a bank that does not itself operate the equipment but instead leases the equipment to an operator.

Paragraph 5

Paragraph 5 makes it clear that the taxing rules of this Article do not apply to the alienation of any right or property that would give rise to royalties, to the extent the gain is contingent on the productivity, use, or further alienation thereof. Such amounts may be taxed in accordance with Article 12 (Royalties) as described in the explanation of paragraph 3 of Article 12.

Paragraph 6

Paragraph 6 grants to the State of residence of the alienator the exclusive right to tax gains from the alienation of property other than property referred to in paragraphs 1 through 5. For example, gain derived from shares, other than shares described in paragraphs 2 or 3, debt instruments and various financial instruments, may be taxed only in the State of residence, to the extent such income is not otherwise characterized as income taxable under another article (e.g., Article 10 (Dividends) or Article 11 (Interest)). Similarly gain derived from the alienation of movable property, other than movable property described in paragraph 3, may be taxed only in the State of residence of the alienator. Sales by a resident of a Contracting State of real property located in a third state are not taxable in the other Contracting State, even if the sale is attributable to a permanent establishment located in the other Contracting State.

Relation to Other Articles

Notwithstanding the foregoing limitations on taxation of certain gains by the State of source, the saving clause of paragraph 4 of Article 1 (General Scope) permits the United States to tax its citizens and residents as if the Convention had not come into effect. Thus, any limitation in this Article on the right of the United States to tax gains does not apply to gains of a U.S. citizen or resident. The benefits of this Article are also subject to the provisions of Article 22 (Limitation on Benefits). Thus, only a resident of a Contracting State that satisfies one of the conditions in Article 22 is entitled to the benefits of this Article.

ARTICLE 14 (INDEPENDENT PERSONAL SERVICES)

The Convention deals in separate articles with different classes of income from personal services. Article 14 deals with the general class of income from independent personal services and Article 15 deals with the general class of income from dependent personal services. Articles 16 through 20 provide exceptions and additions to these general rules for directors' fees (Article 16); performance income of artistes and sportsmen (Article 17); pensions in respect of personal service income, social security benefits, annuities, alimony, and child support payments (Article 18); government service salaries and pensions (Article 19); and certain income of students, trainees and researchers (Article 20).

Paragraph 1

Paragraph 1 of Article 14 provides the general rule that an individual who is a resident of a Contracting State and who derives income from performing personal services in an independent capacity will be exempt from tax in respect of that income by the other Contracting State. The income may be taxed in the other Contracting State only if the services are performed there and the income is attributable to a fixed base that is regularly available to the individual in that other State for the purpose of performing his services.

There is an additional rule in Article 14, which is not in the U.S. or OECD Models. Under this provision, if an individual who is a resident of one Contracting State is present in the other Contracting State for a period or periods aggregating more than 183 days in a 12-month period beginning or ending in the fiscal year concerned, that individual is treated as having a fixed base regularly available to him in that State. All income that the individual derives from services performed in that State will be attributed to that fixed base, if the fixed base is present because of the application of the 183-day rule.

The 183-day period in this Article is to be measured using the "days of physical presence" method. Under this method, the days that are counted include any day in which a part of the day is spent in the host country. (Rev. Rul. 56-24, 1956-1 C.B. 851.) Thus, days that are counted include the days of arrival and departure; weekends and holidays on which the employee does not

work but is present within the country; vacation days spent in the country before, during or after the employment period, unless the individual's presence before or after the employment can be shown to be independent of his presence there for employment purposes; and time during periods of sickness, training periods, strikes, etc., when the individual is present but not working. If illness prevented the individual from leaving the country in sufficient time to qualify for the benefit, those days will not count. Also, any part of a day spent in the host country while in transit between two points outside the host country is not counted. These rules are consistent with the description of the 183-day period in paragraph 5 of the Commentary to Article 15 in the OECD Model.

Income derived by persons other than individuals or groups of individuals from the performance of independent personal services is not covered by Article 14. Such income generally would be business profits taxable in accordance with Article 7 (Business Profits). Income derived by employees of such persons generally would be taxable in accordance with Article 15 (Dependent Personal Services).

The term "fixed base" is not defined in the Convention, but, except for the 183-day rule in this Convention, its meaning is understood to be similar, but not identical, to that of the term "permanent establishment," as defined in Article 5 (Permanent Establishment). The term "regularly available" also is not defined in the Convention. Whether a fixed base is regularly available to a person will be determined based on all the facts and circumstances. In general, the term encompasses situations where a fixed base is at the disposal of the individual whenever he performs services in that State. It is not necessary that the individual regularly use the fixed base, only that the fixed base be regularly available to him. For example, a U.S. resident partner in a law firm that had offices in Estonia would be considered to have a fixed base regularly available to him in Estonia if the law firm had an office there that was available to him whenever he wished to conduct business in Estonia, regardless of how frequently he conducted business there. On the other hand, an individual who had no office in the other State and occasionally rented a hotel room to serve as a temporary office would not be considered to have a fixed base regularly available to him.

The taxing right conferred by this Article with respect to income from independent personal services can, in one respect, be more limited than that provided in Article 7 for the taxation of business profits, although, as described above, it may also be broader in other respects. In both articles the income of a resident of one Contracting State must be attributable to a permanent establishment or fixed base in the other State in order for that other State to have a taxing right. In Article 14 the income also must be attributable to services performed in that other State, while Article 7 does not require that all of the income generating activities be performed in the State where the permanent establishment is located.

This Article applies to income derived by a partner resident in the Contracting State that is attributable to personal services of an independent character performed in the other State through a partnership that has a fixed base in that other Contracting State. Income which may be taxed

under this Article includes all income attributable to the fixed base in respect of the performance of the personal services carried on by the partnership (whether by the partner himself, other partners in the partnership, or by employees assisting the partners) and any income from activities ancillary to the performance of those services (for example, charges for facsimile services). Income that is not derived from the performance of personal services and that is not ancillary thereto (for example, rental income from subletting office space), will be governed by other Articles of the Convention.

The application of Article 14 to a service partnership may be illustrated by the following example: a partnership formed in the Contracting State has five partners (who agree to split profits equally), four of whom are resident and perform personal services only in the Contracting State at Office A, and one of whom performs personal services from Office B, a fixed base in the other State. In this case, the four partners of the partnership resident in the Contracting State may be taxed in the other State in respect of their share of the income attributable to the fixed base, Office B. The services giving rise to income which may be attributed to the fixed base would include not only the services performed by the one resident partner, but also, for example, if one of the four other partners came to the other State and worked on an Office B matter there, the income in respect of those services also. As noted above, this would be the case regardless of whether the partner from the Contracting State actually visited or used Office B when performing services in the other State.

Paragraph 9 of Article 7 (Business Profits) refers to Article 14. That rule clarifies that income that is attributable to a permanent establishment or a fixed base, but that is deferred and received after the permanent establishment or fixed base no longer exists, may nevertheless be taxed by the State in which the permanent establishment or fixed base was located. Thus, under Article 14, income derived by an individual resident of a Contracting State from services performed in the other Contracting State and attributable to a fixed base there may be taxed by that other State even if the income is deferred and received after there is no longer a fixed base available to the resident in that other State.

Paragraph 2

Paragraph 2 of Article 14 provides that the income that is taxable in the Contracting State where the fixed base is located is to be determined in the same way as income from professional services or other activities of an independent character is determined for a resident of that State. It is understood that both Contracting States tax such income on a net income basis. Thus, all relevant expenses, including expenses not incurred in the Contracting State where the fixed base is located, must be allowed as deductions in computing the net income from services subject to tax in the Contracting State where the fixed base is located. Paragraph 2 does not require either Contracting State to grant residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities that it grants to its own residents.

Paragraph 3

Paragraph 3 notes that the term "professional services" includes independent scientific, literary, artistic, educational or teaching activities, as well as the independent activities of physicians, lawyers, engineers, architects, dentists, and accountants. This list, which is derived from the OECD Model, is not exhaustive. The term includes all personal services performed by an individual for his own account, where he receives the income and bears the risk of loss arising from the services. The taxation of income from the types of independent services that are covered by Articles 16 and 18 through 21 is governed by the provisions of those articles. For example, taxation of the income of a corporate director would be governed by Article 16 (Directors' Fees) rather than Article 14.

Relation to Other Articles

If an individual resident of the other Contracting State who is also a U.S. citizen performs independent personal services in the United States, the United States may, by virtue of the saving clause of paragraph 4 of Article 1 (General Scope) tax his income without regard to the restrictions of this Article.

ARTICLE 15 (DEPENDENT PERSONAL SERVICES)

Article 15 apportions taxing jurisdiction over remuneration derived by a resident of a Contracting State as an employee between the States of source and residence.

Paragraph 1

The general rule of Article 15 is contained in paragraph 1. Remuneration derived by a resident of a Contracting State as an employee may be taxed by the State of residence, and the remuneration also may be taxed by that other Contracting State to the extent derived from employment exercised (*i.e.*, services performed) in the other Contracting State. Paragraph 1 also provides that the more specific rules of Articles 16 (Directors' Fees), 18 (Pensions, Social Security, Annuities, Alimony and Child Support), 19 (Government Service) and 20 (Students, Trainees and Researchers) apply in the case of employment income described in one of these articles. Thus, even though the State of source has a right to tax employment income under Article 15, it may not have the right to tax that income under the Convention if the income is described, *e.g.*, in Article 18 (Pensions, Social Security, Annuities, Alimony and Child Support) and is not taxable in the State of source under the provisions of that Article.

Article 15 of the OECD Model applies to "salaries, wages and other similar remuneration." This Convention applies to "salaries, wages and other remuneration." The deletion of "similar" is intended to make it clear that Article 15 applies to any form of compensation for employment, including payments in kind, regardless of whether the remuneration is "similar" to salaries and wages. The interpretation of Article 15 to include in-kind payments is reflected in the addition of paragraph 2.1 to the Commentaries to Article 15 of the OECD Model in 1997.

Consistently with section 864(c)(6), Article 15 also applies regardless of the timing of actual payment for services. Thus, a bonus paid to a resident of a Contracting State with respect to services performed in the other Contracting State with respect to a particular taxable year would be subject to Article 15 for that year even if it was paid after the close of the year. Similarly, an annuity received for services performed in a taxable year would be subject to Article 15 despite the fact that it was paid in subsequent years. In either case, whether such payments were taxable in the State where the employment was exercised would depend on whether the tests of paragraph 2 were satisfied. Consequently, a person who receives the right to a future payment in consideration for services rendered in a Contracting State would be taxable in that State even if the payment is received at a time when the recipient is a resident of the other Contracting State.

Paragraph 2

Paragraph 2 sets forth an exception to the general rule that employment income may be taxed in the State where the employment is exercised. Under paragraph 2, the State where the employment is exercised may not tax the income from the employment if three conditions are satisfied: (a) the individual is present in the other Contracting State for a period or periods not

exceeding 183 days in any 12-month period that begins or ends during the relevant (*i.e.*, the year in which the services are performed) calendar year; (b) the remuneration is paid by, or on behalf of, an employer who is not a resident of that other Contracting State; and (c) the remuneration is not borne by a permanent establishment or fixed base that the employer has in that other State. In order for the remuneration to be exempt from tax in the source State, all three conditions must be satisfied. This exception is identical to that set forth in the U.S. and OECD Models.

The 183-day period in condition (a) is to be measured using the "days of physical presence" method. Under this method, the days that are counted include any day in which a part of the day is spent in the host country. (Rev. Rul. 56-24, 1956-1 C.B. 851.) Thus, days that are counted include the days of arrival and departure; weekends and holidays on which the employee does not work but is present within the country; vacation days spent in the country before, during or after the employment period, unless the individual's presence before or after the employment can be shown to be independent of his presence there for employment purposes; and time during periods of sickness, training periods, strikes, etc., when the individual is present but not working. If illness prevented the individual from leaving the country in sufficient time to qualify for the benefit, those days will not count. Also, any part of a day spent in the host country while in transit between two points outside the host country is not counted. These rules are consistent with the description of the 183-day period in paragraph 5 of the Commentary to Article 15 in the OECD Model.

Conditions (b) and (c) are intended to ensure that a Contracting State will not be required to allow a deduction to the payor for compensation paid and at the same time to exempt the employee on the amount received. Accordingly, if a foreign person pays the salary of an employee who is employed in the host State, but a host State corporation or permanent establishment reimburses the payor with a payment that can be identified as a reimbursement, neither condition (b) nor (c), as the case may be, will be considered to have been fulfilled.

The reference to remuneration "borne by" a permanent establishment or fixed base is understood to encompass all expenses that economically are incurred and not merely expenses that are currently deductible for tax purposes. Accordingly, the expenses referred to include expenses that are capitalizable as well as those that are currently deductible. Further, salaries paid by residents that are exempt from income taxation may be considered to be borne by a permanent establishment or fixed base notwithstanding the fact that the expenses will be neither deductible nor capitalizable since the payor is exempt from tax.

Paragraph 3

Paragraph 3 contains a special rule applicable to remuneration for services performed by an individual resident of one Contracting State as an employee aboard a ship or aircraft operated in international traffic. Under this paragraph, the employment income of such persons may be taxed in the State of residence of the enterprise operating the ship or aircraft. This is not an exclusive taxing right. The State of residence of the employee may also tax the remuneration. This

provision is based on the OECD Model. U.S. internal law does not impose tax on non-U.S. source income of a person who is neither a U.S. citizen nor a U.S. resident, even if that person is an employee of a U.S. resident enterprise. Thus, the United States may not tax the salary of a resident of Estonia who is employed by a U.S. carrier, except as provided in paragraph 2.

Relation to Other Articles

If a U.S. citizen who is resident in Estonia performs services as an employee in the United States and meets the conditions of paragraph 2 for source country exemption, he nevertheless is taxable in the United States by virtue of the saving clause of paragraph 4 of Article 1 (General Scope).

ARTICLE 16 (DIRECTORS' FEES)

This Article provides that a Contracting State may tax the fees paid by a company which is a resident of that State for services performed by an individual resident of the other Contracting State in his capacity as a director of the company. This rule is an exception to the more general rules of Article 14 (Independent Personal Services) and Article 15 (Dependent Personal Services). Thus, a resident of one Contracting State who is a director of a corporation that is resident in the other Contracting State is subject to tax in that other State in respect of his directors' fees regardless of where the services are performed. In determining whether a director's fee is subject to tax in the country of residence of the corporation, whether the fee is attributable to a fixed base is not relevant.

The provision in the Convention is identical to the analogous provision in the OECD Model. The U.S. Model reaches a different result, providing that the State of residence of the company may tax nonresident directors with no time or dollar threshold, but only with respect to remuneration for services performed in that State.

This Article does not grant an exclusive taxing right, nor does it limit the effect of the saving clause of paragraph 4 of Article 1 (General Scope) of the Convention. Thus, if a U.S. citizen is a director of an Estonian corporation, the United States may tax his full remuneration, subject, of course, to any foreign tax credit that may be available.

ARTICLE 17 (ARTISTES AND SPORTSMEN)

This Article deals with the taxation in a Contracting State of artistes (i.e., performing artists and entertainers) and sportsmen resident in the other Contracting State from the performance of their services as such. 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. The rules of this Article take precedence over those of Articles 14 (Independent Personal Services) and 15 (Dependent Personal Services).

This Article applies only with respect to the income of performing artists and sportsmen. Others involved in a performance or athletic event, such as producers, directors, technicians, managers, coaches, etc., remain subject to the provisions of Articles 14 and 15. In addition, except as provided in paragraph 2, income earned by juridical persons is not covered by Article 17.

Paragraph 1

Paragraph 1 describes the circumstances in which a Contracting State may tax the performance income of an entertainer or sportsman who is a resident of the other Contracting State. Under the paragraph, income derived by an individual resident of a Contracting State from activities as an entertainer or sportsman exercised in the other Contracting State may be taxed in that other State if the amount of the gross receipts derived by the performer exceeds \$20,000 (or its equivalent in Estonian kroons) for the taxable year. The \$20,000 includes expenses reimbursed to the individual or borne on his behalf. If the gross receipts exceed \$20,000, the full amount, not just the excess, may be taxed in the State of performance. Tax may be imposed under paragraph 1 even if the performer would have been exempt from tax under Articles 14 (Independent Personal Services) or 15 (Dependent Personal Services).

The OECD Model provides for taxation by the country of performance of the remuneration of entertainers or sportsmen with no dollar or time threshold. This Convention provides the dollar threshold to distinguish between two groups of entertainers and athletes -- those who are paid very large sums of money for very short periods of service, and who would, therefore, normally be exempt from host country tax under the standard personal services income rules, and those who earn relatively modest amounts and are, therefore, not easily distinguishable from those who earn other types of personal service income. The United States has entered a reservation to the OECD Model on this point.

Since it frequently is not possible to know until year-end whether the income an entertainer or sportsman derived from performances in a Contracting State will exceed \$20,000, nothing in the Convention precludes that Contracting State from withholding tax during the year and refunding after the close of the year if the taxability threshold has not been met.

As explained in paragraph 9 of the OECD Commentaries to Article 17, Article 17 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 Contracting State by a performer who is a resident of the other Contracting State from other than actual performance, such as royalties from record sales and payments for product endorsements, is not covered by this Article, but by other articles of the Convention, such as Article 12 (Royalties) or Article 14 (Independent Personal Services). For example, if an entertainer receives royalty income from the sale of live recordings, the royalty income would be taxed by the source country under Article 12 and he could also be taxed in the source country with respect to income from the performance itself under this Article if the dollar threshold is exceeded.

In determining whether income falls under Article 17 or another article, the controlling factor will be whether the income in question is predominantly attributable to the performance itself or other activities or property rights. For instance, a fee paid to a performer for endorsement of a performance in which the performer will participate would be considered to be so closely associated with the performance itself that it normally would fall within Article 17. Similarly, a sponsorship fee paid by a business in return for the right to attach its name to the performance would be so closely associated with the performance that it would fall under Article 17 as well. As indicated in paragraph 9 of the Commentaries to Article 17 of the OECD Model, a cancellation fee would not be considered to fall within Article 17 but would be dealt with under Article 7, 14 or 15.

As indicated in paragraph 4 of the Commentaries to Article 17 of the OECD Model, where 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.

Consistently with Article 15 (Dependent Personal Services), Article 17 also applies regardless of the timing of actual payment for services. Thus, a bonus paid to a resident of a Contracting State with respect to a performance in the other Contracting State with respect to a particular taxable year would be subject to Article 17 for that year even if it was paid after the close of the year.

Paragraph 2

Paragraph 2 is intended to deal with the potential for abuse when a performer's income does not accrue directly to the performer himself, but to another person. Foreign performers frequently perform in the United States as employees of, or under contract with, a company or other person.

The relationship may truly be one of employee and employer, with no abuse of the tax system either intended or realized. On the other hand, the "employer" may, for example, be a company established and owned by the performer, which is merely acting as the nominal income recipient in respect of the remuneration for the performance (a "star company"). The performer may act as an "employee," receive a modest salary, and arrange to receive the remainder of the income from his performance in another form or at a later time. In such case, absent the provisions of paragraph 2, the income arguably could escape host-country tax because the company earns business profits but has no permanent establishment in that country. The performer may largely or entirely escape host-country tax by receiving only a small salary in the year the services are performed, perhaps small enough to place him below the dollar threshold in paragraph 1. The performer might arrange to receive further payments in a later year, when he is not subject to host-country tax, perhaps as deferred salary payments, dividends or liquidating distributions.

Paragraph 2 seeks to prevent this type of abuse while at the same time protecting the taxpayers' rights to the benefits of the Convention when there is a legitimate employee-employer relationship between the performer and the person providing his services. Under paragraph 2, when the income accrues to a person other than the performer, and the performer or related persons participate, directly or indirectly, in the receipts or profits of that other person, the income may be taxed in the Contracting State where the performer's services are exercised, without regard to the provisions of the Convention concerning business profits (Article 7) or independent personal services (Article 14). Thus, even if the "employer" has no permanent establishment or fixed base in the host country, its income may be subject to tax there under the provisions of paragraph 2. Taxation under paragraph 2 is on the person providing the services of the performer. This paragraph does not affect the rules of paragraph 1, which apply to the performer himself. The income taxable by virtue of paragraph 2 is reduced to the extent of salary payments to the performer, which fall under paragraph 1.

For purposes of paragraph 2, income is deemed to accrue to another person (i.e., the person providing the services of the performer) if that other person has control over, or the right to receive, gross income in respect of the services of the performer. Direct or indirect participation in the profits of a person may include, but is not limited to, the accrual or receipt of deferred remuneration, bonuses, fees, dividends, partnership income or other income or distributions.

Paragraph 2 does not apply if it is established that neither the performer nor any persons related to the performer participate directly or indirectly in the receipts or profits of the person providing the services of the performer. Assume, for example, that a circus owned by a U.S. corporation performs in Estonia, and promoters of the performance in Estonia pay the circus, which, in turn, pays salaries to the circus performers. The circus is determined to have no permanent establishment in Estonia. Since the circus performers do not participate in the profits of the circus, but merely receive their salaries out of the circus' gross receipts, the circus is protected by Article 7 and its income is not subject to Estonian tax. Whether the salaries of the

circus performers are subject to Estonian tax under this Article depends on whether they exceed the \$20,000 threshold in paragraph 1.

Since pursuant to Article 1 (General Scope) the Convention only applies to persons who are residents of one of the Contracting States, if the star company is not a resident of one of the Contracting States then taxation of the income is not affected by Article 17 or any other provision of the Convention.

This exception from paragraph 2 for non-abusive cases is not found in the OECD Model. The United States has entered a reservation to the OECD Model on this point.

Paragraph 3

Paragraph 3 of the Article provides an exception to the rules in paragraphs 1 and 2 in the case of a visit to a Contracting State by an entertainer or sportsman who is a resident of the other Contracting State, if the visit is wholly or mainly supported by the public funds of his State of residence or of a political subdivision or local authority of that State. In that case, only the Contracting State of which the entertainer or sportsman is a resident may tax his income from those services. Some other recent U.S. treaties, including the treaties with Germany and France, provide a similar exception.

Relationship to other articles

This Article is subject to the provisions of the saving clause of paragraph 4 of Article 1 (General Scope). Thus, if an entertainer or a sportsman who is resident in Estonia 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. In addition, benefits of this Article are subject to the provisions of Article 22 (Limitation on Benefits).

ARTICLE 18 (PENSIONS, SOCIAL SECURITY, ANNUITIES, ALIMONY, AND CHILD SUPPORT)

This Article deals with the taxation of private (*i.e.*, non-government service) pensions, social security benefits, annuities, alimony and child support payments.

Paragraph 1

Paragraph 1 provides that pensions and other similar remuneration derived and beneficially owned by a resident of a Contracting State in consideration of past employment are taxable only in the State of residence of the beneficiary. The paragraph makes explicit the fact that the term "pensions and other similar remuneration" includes both periodic and lump sum payments.

The phrase “pensions and other similar remuneration” is intended to encompass payments made by private retirement plans and arrangements in consideration of past employment. In the United States, the plans encompassed by Paragraph 1 include: qualified plans under section 401(a), individual retirement plans (including individual retirement plans that are part of a simplified employee pension plan that satisfies section 408(k), individual retirement accounts and section 408(p) accounts), non-discriminatory section 457 plans, section 403(a) qualified annuity plans, and section 403(b) plans. The competent authorities may agree that distributions from other plans that generally meet similar criteria to those applicable to other plans established under their respective laws also qualify for the benefits of Paragraph 1. In the United States, these criteria are as follows:

- a) The plan must be written;
- b) In the case of an employer-maintained plan, the plan must be nondiscriminatory insofar as it (alone or in combination with other comparable plans) must cover a wide range of employees, including rank and file employees, and actually provide significant benefits for the entire range of covered employees;
- c) In the case of an employer-maintained plan the plan must contain provisions that severely limit the employees’ ability to use plan assets for purposes other than retirement, and in all cases be subject to tax provisions that discourage participants from using the assets for purposes other than retirement; and
- d) The plan must provide for payment of a reasonable level of benefits at death, a stated age, or an event related to work status, and otherwise require minimum distributions under rules designed to ensure that any death benefits provided to the participants’ survivors are merely incidental to the retirement benefits provided to the participants.

In addition, certain distribution requirements must be met before distributions from these plans would fall under paragraph 1. To qualify as a pension distribution or similar remuneration from a U.S. plan the employee must have been either employed by the same employer for five years or be at least 62 years old at the time of the distribution. In addition, the distribution must be made either (A) on account of death or disability, (B) as part of a series of substantially equal payments over the employee’s life expectancy (or over the joint life expectancy of the employee and a beneficiary), or (C) after the employee attained the age of 55. Finally, the distribution must be made either after separation from service or on or after attainment of age 65. A distribution from a pension plan solely due to termination of the pension plan is not a distribution falling under paragraph 1.

Pensions in respect of government service are not covered by this paragraph. They are covered either by paragraph 2 of this Article, if they are in the form of social security benefits, or by paragraph 2 of Article 19 (Government Service). Thus, Article 19 covers section 457, 401(a) and 403(b) plans established for government employees. If a pension in respect of government

service is not covered by Article 19 solely because the service is not “in the discharge of functions of a governmental nature,” the pension is covered by this article.

Unlike most U.S. treaties, paragraph 1 provides that, although the State of residence of the beneficiary is given exclusive taxing rights of pension benefits, that State is required to exempt from taxation the amount of any pension that would be excluded from taxable income in the State of source if the recipient were a resident of that State. Thus, if a \$10,000 pension payment arising in Estonia is paid to a resident of the United States, and \$5,000 of such payment would be excluded from taxable income as a return of capital in Estonia if the recipient were a resident of Estonia, the U.S. will exempt from tax \$5,000 of the payment. Only \$5,000 would be so exempt even if Estonia would also grant a personal allowance as a deduction from gross income if the recipient were a resident thereof.

Paragraph 2

The treatment of social security benefits is dealt with in paragraph 2. This paragraph provides that, notwithstanding the provision of paragraph 1, under which private pensions are taxable exclusively in the State of residence of the beneficial owner, payments made by one of the Contracting States under the provisions of its social security or similar legislation to a resident of the other Contracting State or to a citizen of the United States will be taxable only in the Contracting State making the payment. This paragraph applies to social security beneficiaries whether they have contributed to the system as private sector or Government employees.

The phrase "similar legislation" is intended to refer to United States tier 1 Railroad Retirement benefits. The reference to U.S. citizens is necessary to ensure that a social security payment by Estonia to a U.S. citizen who is not resident in the United States will not be taxable by the United States.

Paragraph 3

Under paragraph 3, annuities that are derived and beneficially owned by a resident of a Contracting State are taxable only in that State. An annuity, as the term is used in this paragraph, means a stated sum, other than a pension, which is dealt with in paragraph 1, that is paid periodically at stated times during a specified number of years, under an obligation to make the payment in return for adequate and full consideration (other than for services rendered). An annuity received in consideration for services rendered would be treated as deferred compensation and generally taxable in accordance with Article 15 (Dependent Personal Services).

Paragraphs 4 and 5

Paragraphs 4 and 5 deal with alimony and child support payments. Both alimony, under paragraph 4, and child support payments, under paragraph 5, are defined as periodic payments made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or

compulsory support. Paragraph 4, however, deals only with payments of that type that are deductible to the payer and taxable to the payee. Under that paragraph, alimony (*i.e.*, a deductible payment that is taxable in the hands of the recipient) paid by a resident of a Contracting State to a resident of the other Contracting State is taxable under the Convention only in the State of residence of the recipient. Paragraph 5 deals with those periodic payments that are for the support of a child and that are not covered by paragraph 4 (*i.e.*, those payments that either are not deductible to the payer or not taxable to the payee). These types of payments by a resident of a Contracting State to a resident of the other Contracting State are not taxable in the State of residence of the payee.

Relationship to other Articles

Paragraphs 1, 3 and 4 of Article 18 are subject to the saving clause of paragraph 4 of Article 1 (General Scope). Thus, a U.S. citizen who is resident in the other Contracting State, and receives either a pension, annuity or alimony payment from the United States, may be subject to U.S. tax on the payment, notwithstanding the rules in those three paragraphs that give the State of residence of the recipient the exclusive taxing right. Paragraphs 2 and 5, however, are excepted from the saving clause by virtue of paragraph 5(a) of Article 1. Thus, the United States will allow U.S. citizens and residents the benefits of those paragraphs.

ARTICLE 19 (GOVERNMENT SERVICE)

Paragraph 1

Subparagraphs (a) and (b) of paragraph 1 deal with the taxation of government compensation (other than a pension addressed in paragraph 2). Subparagraph (a) provides that remuneration paid by one of the States or its political subdivisions or local authorities to any individual who is rendering services to that State, political subdivision or local authority, as an employee of that State, political subdivision or local authority, is exempt from tax by the other State. Under subparagraph (b), such payments are, however, taxable exclusively in the other State (i.e., the host State) if the services are rendered in that other State and the individual is a resident of that State who is either a national of that State or a person who did not become a resident of that State solely for purposes of rendering the services.

This paragraph is consistent with the OECD Model, but differs from the U.S. Model, in that it applies only to government employees and not to independent contractors engaged by governments to perform services for them. Independent contractors who provide services for a government or government agency are subject to the provisions of Article 14 (Independent Personal Services), and not this Article.

The remuneration described in paragraph 1 is subject to the provisions of this paragraph and not to those of Articles 15 (Dependent Personal Services) or 17 (Artistes and Sportsmen). If, however, the conditions of paragraph 1 are not satisfied, those other Articles will apply. Thus, if a local government runs a business, even though the employees who are working for the business are employees of the local government, the compensation of those employees is covered by Article 15 and not Article 19, because the employees are not engaging in a governmental function when they perform their employment duties. Further, the remuneration of artistes or sportsmen who are performing in one Contracting State and are sponsored by the government of the other Contracting State is taxable under paragraph 3 of Article 17 (Artistes and Sportsmen) only in the State sponsoring the performance. Such remuneration is not taxable under this Article because such performers are not employees of the government nor are they discharging functions of a governmental nature.

Paragraph 2

Paragraph 2 deals with the taxation of a pension paid by or from the public funds of one of the States or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority in the discharge of governmental functions. Subparagraph (a) provides that such a pension is taxable only in that State. Subparagraph (b) provides an exception under which such a pension is taxable only in the other State if the individual is a resident of, and a national of, that other State. Pensions paid to retired civilian and military employees of a Government of either State are intended to be covered under paragraph 2. When benefits paid by a State in respect of services rendered to that State or a

subdivision or authority are in the form of social security benefits, however, those payments are covered by paragraph 2 of Article 18 (Pensions, Social Security, Annuities, Alimony, and Child Support). As a general matter, the result will be the same whether Article 18 or 19 applies, since social security benefits are taxable exclusively by the source country and so, as a general matter, are government pensions. The result will differ only when the payment is made to a citizen and resident of the other Contracting State, who is not also a citizen of the paying State. In such a case, social security benefits continue to be taxable at source while government pensions become taxable only in the residence country.

The phrase "functions of a governmental nature" is not defined. In general it is understood to encompass functions traditionally carried on by a government. It generally would not include functions that commonly are found in the private sector (e.g., education, health care, utilities). Rather, it is limited to functions that generally are carried on solely by the government (e.g., military, diplomatic service, tax administrators) and activities that directly support the carrying out of those functions.

The use of the phrase "paid from the public funds of a Contracting State" is intended to clarify that remuneration and pensions paid by such entities as government-owned corporations are covered by the Article, as long as the other conditions of the Article are satisfied.

Relation to other Articles

Under paragraph 5(b) of Article 1 (General Scope), the saving clause (paragraph 4 of Article 1) does not apply to the benefits conferred by one of the States under Article 19 if the recipient of the benefits is neither a citizen of that State, nor a person who has been admitted for permanent residence there (i.e., in the United States, a "green card" holder). Thus, a resident of Estonia, who in the course of performing functions of a governmental nature becomes a resident of the United States (but not a permanent resident), would be entitled to the benefits of this Article. However, an individual who receives a pension paid by the Government of Estonia in respect of services rendered to that Government is taxable on that pension only in Estonia unless the individual is a U.S. citizen or acquires a U.S. green card.

ARTICLE 20 (STUDENTS, TRAINEES AND RESEARCHERS)

This Article deals with visiting students, trainees and researchers. Unlike the U.S. Model, which deals only with maintenance, education or training payments that arise outside the host State, the Article also provides limited earned income exemption for persons covered by the Article, in order to reflect the particular economic and cultural relationships in this area between the United States and Estonia.

Paragraph 1

Paragraph 1 of this Article generally provides that a resident of a Contracting State who visits the other Contracting State for the primary purpose of studying at a university or other recognized educational institution, securing training in a professional specialty, or studying or doing research as the recipient of a grant from a government or a charitable institution shall be exempt from tax in that Contracting State with respect to certain items of income derived during that period of study, research or training, provided certain conditions are met. Subparagraph 1(b) defines those exempt items of income as: (1) payments from abroad for maintenance, education, study, research, or training; (2) grants, allowances or awards; and (3) income from personal services performed in that other Contracting State to the extent of \$5,000 United States dollars or its equivalent in Estonian kroons per taxable year. The exemptions provided in paragraph 1 are available to the visiting student or trainee for a period not exceeding five taxable years from the beginning of the visit. The religious, charitable, etc. organization, described in subparagraph 1(a) (iii) is, for U.S. purposes, an organization that qualifies as tax-exempt under Code section 501(c)(3).

The exemption threshold in this, and subsequent paragraphs of the Article, applies in addition to, and not in lieu of, any allowances (e.g., personal exemptions and deductions) available to the person under the internal laws of the Contracting States. If the amount earned exceeds \$5,000 per annum, under this paragraph, only the excess is taxable.

The reference in paragraph 1 to "primary purpose" is meant to describe individuals who are participating in a full time program of study, training or research. "Primary purpose" was substituted for the reference in the OECD Model to "exclusive purpose" to prevent too narrow an interpretation. It is not the intention, for example, to exclude full time students who, in accordance with their visas, may hold part-time employment.

A student must be studying at a university or other accredited educational institution to qualify for the benefits of this Article. An educational institution is understood to be an institution that normally maintains a regular faculty and normally has a regular body of students in attendance at the place where the educational activities are carried on. An educational institution will be considered to be accredited if it is accredited by an authority that generally is responsible for accreditation of institutions in the particular field of study.

The host-country exemption in the Article applies in subparagraph (b)(i) to payments received by the student, trainee or researcher from abroad for the purpose of his maintenance, education or training. A payment will be considered to be from abroad if the payer is located outside the host State. In all cases substance over form will prevail in determining the location and/or identity of the payer. Consequently, payments made directly or indirectly by the U.S. person with whom the visitor is training, but which have been routed through a non-host-country, such as, for example, a foreign affiliated organization, should not be treated as arising outside the United States for this purpose. Moreover, if a U.S. person reimbursed a foreign person for payments by the foreign person to the visitor, the payments by the foreign person would not be treated as arising outside the United States.

Paragraph 2

Paragraph 2 deals with an individual resident of a Contracting State who is an employee of, or under contract with, an enterprise of that State, and who is temporarily present in the other Contracting State for the primary purpose of studying at an accredited educational institution in the host State or acquiring technical, professional or business experience from a person other than his employer. Such resident will be exempt from tax by the host State for a period of 12 consecutive months on compensation for personal services in an aggregate amount not exceeding \$8,000 or its equivalent in Estonian kroons.

Paragraph 3

Paragraph 3 of the Article deals with an individual resident of a Contracting State who is temporarily present in the other Contracting State for a period not exceeding one year, as a participant in a program sponsored by the Government of the host State, for the primary purpose of training, research or study. Such an individual will be exempt from tax by the host State on compensation for personal services in respect of such training, research or study performed in the host State in an aggregate amount not exceeding \$10,000 or its equivalent in Estonian kroons.

Paragraph 4

Paragraph 4 clarifies that, for the exemption of the preceding paragraphs to apply to income from research, the research must be undertaken in the public interest, and not primarily for the private benefit of a specific person or persons. For example, the exemption would not apply to a grant from a tax-exempt research organization to search for the cure to a disease if the results of the research become the property of a for-profit company. The exemption would not be denied, however, if the tax-exempt organization licensed the results of the research to a for-profit enterprise in consideration of an arm's length royalty consistent with its tax-exempt status.

Relation to Other Articles

Under paragraph 5(b) of Article 1 (General Scope), the saving clause (paragraph 4 of Article 1) does not apply to this Article if the individual is neither a citizen of the host State nor admitted for permanent residence there. The saving clause, however, does apply with respect to citizens and permanent residents of the host State. Thus, a U.S. citizen who is a resident of Estonia and who visits the United States as a full time student at an accredited university will not be exempt from U.S. tax on remittances from abroad that otherwise constitute U.S. taxable income. A person, however, who is not a U.S. citizen, and who visits the United States as a student and remains long enough to become a resident under U.S. tax law, but does not become a permanent resident (i.e., does not acquire a green card), will be entitled to the full benefits of the Article.

Under subparagraph (g) of paragraph 3 of Article 25 (Mutual Agreement Procedure), the competent authorities of the Contracting States may, by mutual agreement, increase any or all of the dollar thresholds in this article.

ARTICLE 21(OTHER INCOME)

This Article provides the rules for the taxation of items of income not dealt with in the other Articles of the Convention. An item of income is "dealt with" in another article if it is the type of income described in the Article and it has its source in a Contracting State. For example, all royalty income that arises in a Contracting State and that is beneficially owned by a resident of the other Contracting State is "dealt with" in Article 12 (Royalties). Article 21 of the Convention differs from Article 21 (Other Income) of the U.S. Model. Like the U.S. Model, the Article generally assigns taxing jurisdiction over income not dealt with in the other articles (Articles 6 through 20) of the Convention to the State of residence of the beneficial owner of the income and defines the terms necessary to apply the Article. Unlike the U.S. Model, paragraph 3 of this Article also allows the other Contracting State to tax in cases where the income of a resident of a Contracting State has its source in the other Contracting State.

This Article deals both with types of income which are not dealt with elsewhere, such as, for example, lottery winnings, and also with income of a type dealt with elsewhere in the Convention, but from sources in third States, and, therefore, not covered by the other Articles.

Examples of items of income covered by Article 21 include income from gambling, punitive (but not compensatory) damages, covenants not to compete, and income from financial instruments to the extent derived by persons not engaged in the trade or business of dealing in such instruments (unless the transaction giving rise to the income is related to a trade or business, in which case it is dealt with under Article 7 (Business Profits)). The Article also applies to items of income that are not dealt with in the other articles because of their source or some other characteristic. For example, Article 11 (Interest) addresses only the taxation of interest arising in a Contracting State. Interest arising in a third State that is not attributable to a permanent establishment, therefore, is subject to Article 21.

Distributions from partnerships and distributions from trusts are not generally dealt with under Article 21 because partnership and trust distributions generally do not constitute income. Under the Code, partners include in income their distributive share of partnership income annually, and partnership distributions themselves generally do not give rise to income. Also, under the Code, trust income and distributions have the character of the associated distributable net income and therefore would generally be covered by another article of the Convention. See Code section 641 et seq.

Paragraph 1

The general rule of Article 21 is contained in paragraph 1. Items of income not dealt with in other articles and beneficially owned by a resident of a Contracting State will be taxable only in the State of residence. This exclusive right of taxation applies whether or not the residence State exercises its right to tax the income covered by the Article. Paragraph 3 of this Article alters this

exclusive right of taxation in cases where the income of a resident of a Contracting State is sourced in the other Contracting State.

The reference in this paragraph to "items of income beneficially owned by a resident of a Contracting State" rather than simply "items of income of a resident of a Contracting State," as in the OECD Model, is intended merely to make explicit the implicit understanding in other treaties that the exclusive residence taxation provided by paragraph 1 applies only when a resident of a Contracting State is the beneficial owner of the income. Thus, source taxation of income not dealt with in other articles of the Convention is not limited by paragraph 1 if it is nominally paid to a resident of the other Contracting State, but is beneficially owned by a resident of a third State.

Paragraph 2

This paragraph provides an exception to the general rule of paragraph 1 for income, other than income from real property, that is attributable to a permanent establishment or fixed base maintained in a Contracting State by a resident of the other Contracting State. The taxation of such income is governed by the provisions of Articles 7 (Business Profits) and 14 (Independent Personal Services). Therefore, income arising outside the United States that is attributable to a permanent establishment maintained in the United States by a resident of Estonia generally would be taxable by the United States under the provisions of Article 7. This would be true even if the income is sourced in a third State.

There is an exception to this general rule with respect to income a resident of a Contracting State derives from real property located outside the other Contracting State (whether in the first-mentioned Contracting State or in a third State) that is attributable to the resident's permanent establishment or fixed base in the other Contracting State. In such a case, only the first-mentioned Contracting State (*i.e.*, the State of residence of the person deriving the income) and not the host State of the permanent establishment or fixed base may tax that income. This special rule for foreign-situs property is consistent with the general rule, also reflected in Article 6 (Income from Immovable (Real) Property), that only the situs and residence States may tax real property and real property income. Even if such property is part of the property of a permanent establishment or fixed base in a Contracting State, that State may not tax it if neither the situs of the property nor the residence of the owner is in that State.

Paragraph 3

Paragraph 3 provides that where an item of income of a resident of a Contracting State dealt with in Paragraph 1 is sourced in the other Contracting State, the State of source also may tax the income. This does not grant exclusive taxing rights to the source State. Income attributable to notional principal contracts and other financial instruments to the extent that the income is attributable to a trade or business 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) that is derived by a resident of one Contracting State in connection with the conduct of a trade or business situated in the other Contracting State is taxable as business profits under Article 7 (Business Profits) and not under this Article.

Relation to Other Articles

This Article is subject to the saving clause of paragraph 4 of Article 1 (General Scope). Thus, the United States may tax the income of a resident of Estonia that is not dealt with elsewhere in the Convention, if that resident is a citizen of the United States. The Article is also subject to the provisions of Article 22 (Limitation on Benefits). Thus, if a resident of Estonia earns income that falls within the scope of paragraph 1 of Article 21, but that is taxable by the United States under U.S. law, the income would be exempt from U.S. tax under the provisions of Article 21 only if the resident satisfies one of the tests of Article 22 for entitlement to benefits.

ARTICLE 22 (LIMITATION OF BENEFITS)

Purpose of Limitation on Benefits Provisions

The United States views an income tax treaty as a vehicle for providing treaty benefits to residents of the two Contracting States. This statement begs the question of who is to be treated as a resident of a Contracting State for the purpose of being granted treaty benefits. The Commentaries to the OECD Model authorize a tax authority to deny benefits, under substance-over-form principles, to a nominee in one State deriving income from the other on behalf of a third-country resident. In addition, although the text of the OECD Model does not contain express anti-abuse provisions, the Commentaries to Article 1 contain an extensive discussion approving the use of such provisions in tax treaties in order to limit the ability of third state residents to obtain treaty benefits. The United States holds strongly to the view that tax treaties should include provisions that specifically prevent misuse of treaties by residents of third countries. Consequently, all recent U.S. income tax treaties contain comprehensive Limitation on Benefits provisions.

A treaty that provides treaty benefits to any resident of a Contracting State permits "treaty shopping": the use, by residents of third states, of legal entities established in a Contracting State with a principal purpose to obtain the benefits of a tax treaty between the two Contracting States. It is important to note that this definition of treaty shopping does not encompass every case in which a third state resident establishes an entity in a treaty partner, and that entity enjoys treaty benefits to which the third state resident would not itself be entitled. If the third country resident had substantial reasons for establishing the structure that were unrelated to obtaining treaty benefits, the structure would not fall within the definition of treaty shopping set forth above.

Of course, the fundamental problem presented by this approach is that it is based on the taxpayer's intent, which a tax administrator is normally ill-equipped to identify. In order to avoid the necessity of making this subjective determination, Article 22 sets forth a series of objective tests. The assumption underlying each of these tests is that a taxpayer that satisfies the requirements of any of the tests probably has a real business purpose for the structure it has adopted, or has a sufficiently strong nexus to the other Contracting State (*e.g.*, a resident individual) to warrant benefits even in the absence of a business connection, and that this business purpose or connection is sufficient to justify the conclusion that obtaining the benefits of the Treaty is not a principal purpose of establishing or maintaining residence.

For instance, the assumption underlying the active trade or business test under paragraph 3 is that a third country resident that establishes a "substantial" operation in Estonia and that derives income from a related activity in the United States would not do so primarily to avail itself of the benefits of the Treaty; it is presumed in such a case that the investor had a valid business purpose for investing in Estonia, and that the link between that trade or business and the U.S. activity that generates the treaty-benefitted income manifests a business purpose for placing the U.S. investments in the entity in Estonia. It is considered unlikely that the investor would incur the

expense of establishing a substantial trade or business in Estonia simply to obtain the benefits of the Convention. A similar rationale underlies other tests in Article 22.

While these tests provide useful surrogates for identifying actual intent, these mechanical tests cannot account for every case in which the taxpayer was not treaty shopping. Accordingly, Article 22 also includes a provision (paragraph 4) authorizing the competent authority of a Contracting State to grant benefits. While an analysis under paragraph 4 may well differ from that under one of the other tests of Article 22, its objective is the same: to identify investors whose residence in the other State can be justified by factors other than a purpose to derive treaty benefits.

Article 22 and the anti-abuse provisions of domestic law complement each other, as Article 22 effectively determines whether an entity has a sufficient nexus to the Contracting State to be treated as a resident for treaty purposes, while domestic anti-abuse provisions (e.g., business purpose, substance-over-form, step transaction or conduit principles) determine whether a particular transaction should be recast in accordance with its substance. Thus, internal law principles of the source State may be applied to identify the beneficial owner of an item of income, and Article 22 then will be applied to the beneficial owner to determine if that person is entitled to the benefits of the Convention with respect to such income.

Structure of the Article

The structure of the Article is as follows: Paragraph 1 states the general rule that residents are entitled to benefits otherwise accorded to residents only if the resident is a “qualified resident,” as defined in the Article. Paragraph 2 lists a series of attributes of a qualified resident, the presence of any one of which will entitle that person to all the benefits of the Convention. Paragraph 3 provides that, with respect to a person that is not a qualified resident, and is, therefore, not entitled to benefits under paragraph 2, benefits nonetheless may be granted to that person with regard to certain types of income. Paragraph 4 provides that benefits also may be granted to a person that is not a qualified person if the competent authority of the State from which benefits are claimed determines that it is appropriate to provide benefits in that case. Paragraph 5 defines the term “recognized stock exchange” as used in paragraph 2(e).

Paragraph 1

Paragraph 1 provides that a resident of a Contracting State will be entitled to the benefits otherwise accorded to residents of a Contracting State under the Convention only if it is a qualified resident as provided in the Article. The benefits otherwise accorded to residents under the Convention include all limitations on source-based taxation under Articles 6 through 21, the treaty-based relief from double taxation provided by Article 23 (Relief from Double Taxation), and the protection afforded to residents of a Contracting State under Article 24 (Non-Discrimination). Some provisions do not require that a person be a resident in order to enjoy the benefits of those provisions. These include paragraph 1 of Article 24 (Non-Discrimination),

Article 25 (Mutual Agreement Procedure), and Article 27 (Member of Diplomatic Missions and Consular Posts). Article 22 accordingly does not limit the availability of the benefits of these provisions.

Paragraph 2

Paragraph 2 has seven subparagraphs, each of which describes a category of residents that can be a qualified resident and thus enjoy the benefits of the Convention.

It is intended that the provisions of paragraph 2 will be self-executing. Unlike the provisions of paragraph 4, discussed below, claiming benefits under paragraph 2 does not require advance competent authority ruling or approval. The tax authorities may, of course, on review, determine that the taxpayer has improperly interpreted the paragraph and is not entitled to the benefits claimed.

Individuals -- Subparagraph 2(a)

Subparagraph (a) provides that individual residents of a Contracting State are qualified residents and thus will be entitled to all treaty benefits. If such an individual receives income as a nominee on behalf of a third country resident, benefits may be denied under the respective articles of the Convention by the requirement that the beneficial owner of the income be a resident of a Contracting State.

Contracting State -- Subparagraph 2(b)

Subparagraph (b) provides that certain governmental entities also will be entitled to all benefits of the Convention. These include the entities listed under paragraph 3 (a) of Article 4 (Resident) which include a Contracting State, a political subdivision or a local authority thereof, or an agency or instrumentality of such State, subdivision or authority.

Ownership/Base Erosion -- Subparagraph 2(c)(i)

Subparagraph 2(c) provides a two part test, the so-called ownership and base erosion test. This test applies under subparagraph 2(c) to a company that is a resident of a Contracting State. As described below, the rules of subparagraph 2(c) also apply, in accordance with subparagraph 2 (d), to a trust or estate that is a resident of a Contracting State. Both prongs of the test must be satisfied for the resident to be entitled to benefits under subparagraph 2(c).

The ownership prong of the test, under clause (i), requires that on at least half the days of the taxable year the beneficial owners of at least 50 percent of each class of the company's shares be owned by qualified residents by reason of subparagraphs (a), (b), (e) or (f). The ownership may be indirect through other persons, each of which are, themselves, entitled to benefits under paragraph 2.

The base erosion prong of the test under subparagraph 2(c)(ii) requires that less than 50 percent of the company's gross income for the taxable year be paid or accrued, directly or indirectly, to persons who are not qualified residents of either State nor U.S. citizens (unless income is attributable to a permanent establishment located in either Contracting State), in the form of payments that are deductible for tax purposes in the entity's State of residence. Depreciation and amortization deductions, which are not "payments," are disregarded for this purpose. Payments made at arm's length in the ordinary course of business for services or tangible property also are disregarded for the purposes of applying the base-erosion rule. The purpose of this provision is to determine whether the income derived from the source State is in fact subject to the tax regime of either State. Consequently, payments to any qualified resident of either State or U.S. citizens, are not considered base eroding payments for this purpose (to the extent that these recipients do not themselves base erode to non-residents).

The term "gross income" is not defined in the Convention. Thus, in accordance with paragraph 2 of Article 3 (General Definitions), in determining whether a person deriving income from United States sources is entitled to the benefits of the Convention, the United States will ascribe the meaning to the term that it has in the United States. In such cases, "gross income" will be defined as gross receipts less cost of goods sold.

Trusts or Estates – Subparagraph 2(d)

Trusts and estates may be entitled to benefits under this provision if they are treated as residents under Article 4 (Residence) and they satisfy the requirements of subparagraph 2(c). For purposes of the application of subparagraph 2(c)(i) to trusts, the beneficial interests in a trust or estate will be considered to be owned by its beneficiaries in proportion to each beneficiary's actuarial interest in the trust or estate. The interest of a remainder beneficiary will be equal to 100 percent less the aggregate percentages held by income beneficiaries. A beneficiary's interest in a trust or estate will not be considered to be owned by a person entitled to benefits under the other provisions of paragraph 2 if it is not possible to determine the beneficiary's actuarial interest. Consequently, if it is not possible to determine the actuarial interest of any beneficiaries in a trust or estate, the ownership test under clause (i) cannot be satisfied, unless all beneficiaries are persons entitled to benefits under the other subparagraphs of paragraph 2.

For purposes of the application of subparagraph 2(c)(ii) to trusts and estates, distributions would be considered deductible payments to the extent they are deductible from the taxable base.

Publicly Traded Persons -- Subparagraph 2(e)

Subparagraph (e) applies to two categories of persons: publicly-traded persons and subsidiaries of publicly-traded persons. Clause (i) of subparagraph 2(e) provides that a person will be entitled to all the benefits of the Convention if all the beneficial interests representing at least 50 percent of the value of each class of interests in the person are regularly traded on a

"recognized stock exchange." The term "recognized stock exchange" is defined in paragraph 5.-If the person is a corporation "shares" would be considered to be the equivalent of "interests".

If a person has only one class of interests, it is only necessary to consider whether the interests of that class are regularly traded on a recognized stock exchange. If the person has more than one class of interests, it is necessary to make this determination for each class.

The term "substantially and regularly traded" is not defined in the Convention. Interests are considered to be "substantially and regularly traded" if two requirements are met: trades in the class of interests are made in more than de minimis quantities on at least 60 days during the taxable year, and the aggregate number of interests in the class traded during the year is at least 6 percent of the average number of interests outstanding during the year. Authorized but unissued interests are not considered for purposes of this test.

The regular trading requirement can be met by trading on any recognized exchange or exchanges located in either State, or, if the competent authorities so agree, in a third State. Trading on one or more recognized stock exchanges may be aggregated for purposes of this requirement. Thus, a U.S. person could satisfy the regularly traded requirement through trading, in whole or in part, on a recognized stock exchange located in Estonia.

Tax Exempt Organizations and Pension Funds -- Subparagraph 2(f)

Subparagraph 2(f) provides that the tax exempt organizations and pension funds described in subparagraph 3(b) of Article 4 (Resident) will be entitled to all the benefits of the Convention as long as more than half of the beneficiaries, members or participants of the organization, if any, are qualified residents of either Contracting. Tax exempt entities described in subparagraph 3(b) of Article 4 are entities that generally are exempt from tax in their State of residence because they are organized and operated exclusively to fulfill religious, educational, scientific and other charitable purposes. Pension funds are tax-exempt entities that provide pension and other benefits to employees pursuant to a plan. For purposes of this provision, the term "beneficiaries" should be understood to refer to the persons receiving benefits from the organization.

Regulated Investment Companies-- Subparagraph 2(g)

Subparagraph (g) provides that Regulated Investment Companies, or similar entities in Estonia as may be agreed by the competent authorities of the Contracting States, will be entitled to all benefits of the Convention.

Paragraph 3

Paragraph 3 sets forth a test under which a resident of a Contracting State that is not generally entitled to benefits of the Convention under paragraph 2 may receive treaty benefits with

respect to certain items of income that are connected to an active trade or business conducted in its State of residence.

Subparagraph 3(a) sets forth a three-pronged test that must be satisfied in order for a resident of a Contracting State to be entitled to the benefits of the Convention with respect to a particular item of income. First, the resident must be engaged in the active conduct of a trade or business in its State of residence. Second, the income derived from the other State must be derived in connection with, or be incidental to, that trade or business. Third, if there is common ownership of the activities in both States, the trade or business must be substantial in relation to the activity in the other State that generated the item of income. These determinations are made separately for each item of income derived from the other State. It therefore is possible that a person would be entitled to the benefits of the Convention with respect to one item of income but not with respect to another. If a resident of a Contracting State is entitled to treaty benefits with respect to a particular item of income under paragraph 3, the resident is entitled to all benefits of the Convention insofar as they affect the taxation of that item of income in the other State. Set forth below is a discussion of each of the three prongs of the test under paragraph 3.

Trade or Business -- Subparagraphs 3(a)(i) and (b)

The term "trade or business" is not defined in the Convention. Pursuant to paragraph 2 of Article 3 (General Definitions), when determining whether a resident of the other State is entitled to the benefits of the Convention under paragraph 3 with respect to income derived from U.S. sources, the United States will ascribe to this term the meaning that it has under the law of the United States. Accordingly, the United States competent authority will refer to the regulations issued under section 367(a) for the definition of the term "trade or business." In general, therefore, a trade or business will be considered to be a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit. Furthermore, a corporation generally will be considered to carry on a trade or business only if the officers and employees of the corporation conduct substantial managerial and operational activities. See, Code section 367(a)(3) and the regulations thereunder.

Notwithstanding this general definition of trade or business, subparagraph 3(b) provides that the business of making or managing investments, will be considered to be a trade or business only when part of banking, insurance or securities activities conducted by a bank, insurance company, or registered securities dealer. Conversely, such activities conducted by a person other than a bank, insurance company or registered securities dealer will not be considered to be the conduct of an active trade or business, nor would they be considered to be the conduct of an active trade or business if conducted by a bank, insurance company, or registered securities dealer, but not as part of the company's banking, insurance or dealer business.

Because a headquarters operation is in the business of managing investments, a company that functions solely as a headquarter company will not be considered to be engaged in an active trade or business for purposes of paragraph 3.

Derived in Connection With Requirement - Subparagraphs 3(a)(ii) and (d)

Subparagraph 3(d) provides that income is derived in connection with a trade or business if the income-producing activity in the other State is a line of business that forms a part of or is complementary to the trade or business conducted in the State of residence by the income recipient. Although no definition of the terms "forms a part of" or "complementary" is set forth in the Convention, it is intended that a business activity generally will be considered to "form a part of" a business activity conducted in the other State if the two activities involve the design, manufacture or sale of the same products or type of products, or the provision of similar services. In order for two activities to be considered to be "complementary," the activities need not relate to the same types of products or services, but they should be part of the same overall industry and be related in the sense that the success or failure of one activity will tend to result in success or failure for the other. In cases in which more than one trade or business is conducted in the other State and only one of the trades or businesses forms a part of or is complementary to a trade or business conducted in the State of residence, it is necessary to identify the trade or business to which an item of income is attributable. Royalties generally will be considered to be derived in connection with the trade or business to which the underlying intangible property is attributable. Dividends will be deemed to be derived first out of earnings and profits of the treaty-benefitted trade or business, and then out of other earnings and profits. Interest income may be allocated under any reasonable method consistently applied. A method that conforms to U.S. principles for expense allocation will be considered a reasonable method. The following examples illustrate the application of subparagraph 3(d).

Example 1. USCo is a corporation resident in the United States. USCo is engaged in an active manufacturing business in the United States. USCo owns 100 percent of the shares of Estco, a corporation resident in Estonia. Estco distributes USCo products in Estonia. Since the business activities conducted by the two corporations involve the same products, Estco's distribution business is considered to form a part of USCo's manufacturing business within the meaning of subparagraph 3(d).

Example 2. The facts are the same as in Example 1, except that USCo does not manufacture. Rather, USCo operates a large research and development facility in the United States that licenses intellectual property to affiliates worldwide, including Estco. Estco and other USCo affiliates then manufacture and market the USCo-designed products in their respective markets. Since the activities conducted by Estco and USCo involve the same product lines, these activities are considered to form a part of the same trade or business.

Example 3. Americair is a corporation resident in the United States that operates an international airline. EstSub is a wholly-owned subsidiary of Americair resident in Estonia. Estsub operates a chain of hotels in Estonia that are located near airports served by Americair flights. Americair frequently sells tour packages that include air travel to Estonia and lodging at Estsub hotels. Although both companies are engaged in the active conduct of a trade or business, the businesses of operating a chain of hotels and operating an airline are distinct trades or

businesses. Therefore Estsub's business does not form a part of Americair's business. However, Estsub's business is considered to be complementary to Americair's business because they are part of the same overall industry (travel) and the links between their operations tend to make them interdependent.

Example 4. The facts are the same as in Example 3, except that Estsub owns an office building in Estonia instead of a hotel chain. No part of Americair's business is conducted through the office building. Estsub's business is not considered to form a part of or to be complementary to Americair's business. They are engaged in distinct trades or businesses in separate industries, and there is no economic dependence between the two operations.

Example 5. USFlower is a corporation resident in the United States. USFlower produces and sells flowers in the United States and other countries. USFlower owns all the shares of EstHolding, a corporation resident in Estonia. EstHolding is a holding company that is not engaged in a trade or business. EstHolding owns all the shares of three corporations that are resident in Estonia: EstFlower, EstLawn, and EstFish. EstFlower distributes USFlower flowers under the USFlower trademark in the other State. EstLawn markets a line of lawn care products in the other State under the USFlower trademark. In addition to being sold under the same trademark, EstLawn and EstFlower products are sold in the same stores and sales of each company's products tend to generate increased sales of the other's products. EstFish imports fish from the United States and distributes it to fish wholesalers in Estonia. For purposes of paragraph 3, the business of EstFlower forms a part of the business of USFlower, the business of EstLawn is complementary to the business of USFlower, and the business of EstFish is neither part of nor complementary to that of USFlower.

Finally, a resident in one of the States also will be entitled to the benefits of the Convention with respect to income derived from the other State if the income is "incidental" to the trade or business conducted in the recipient's State of residence. Subparagraph 3(d) provides that income derived from a State will be incidental to a trade or business conducted in the other State if the production of such income facilitates the conduct of the trade or business in the other State. An example of incidental income is the temporary investment of working capital derived from a trade or business.

Substantiality -- Subparagraphs 3(a)(iii) and (c)

As indicated above, subparagraph 3(a)(iii) provides that income that a resident of a State derives from the other State will be entitled to the benefits of the Convention under paragraph 3 only if the income is derived in connection with a trade or business conducted in the recipient's State of residence and that trade or business is "substantial" in relation to the income-producing activity in the other State. Subparagraph 3(c) provides that whether the trade or business of the income recipient is substantial will be determined based on all the facts and circumstances. These circumstances generally would include the relative scale of the activities conducted in the two

States and the relative contributions made to the conduct of the trade or businesses in the two States.

In addition to this subjective rule, subparagraph 3(c) provides a safe harbor under which the trade or business of the income recipient may be deemed to be substantial based on three ratios that compare the size of the recipient's activities to those conducted in the other State. The three ratios compare: (i) the value of the assets in the recipient's State to the assets used in the other State; (ii) the gross income derived in the recipient's State to the gross income derived in the other State; and (iii) the payroll expense in the recipient's State to the payroll expense in the other State. The average of the three ratios with respect to the preceding taxable year must exceed 10 percent, and each individual ratio must exceed 7.5 percent. If any individual ratio does not exceed 7.5 percent for the preceding taxable year, the average for the three preceding taxable years may be used instead. Thus, if the taxable year is 2002, the preceding year is 2001. If one of the ratios for 2001 is not greater than 7.5 percent, the average ratio for 1999, 2000, and 2001 with respect to that item may be used.

The term "value" also is not defined in the Convention. Therefore, this term also will be defined under U.S. law for purposes of determining whether a person deriving income from United States sources is entitled to the benefits of the Convention. In such cases, "value" generally will be defined using the method used by the taxpayer in keeping its books for purposes of financial reporting in its country of residence. See, Treas. Reg. 1.884-5(e)(3)(ii)(A).

Only items actually located or incurred in the two Contracting States are included in the computation of the ratios. If the person from whom the income in the other State is derived is not wholly-owned by the recipient (and parties related thereto) then the items included in the computation with respect to such person must be reduced by a percentage equal to the percentage control held by persons not related to the recipient. For instance, if a United States corporation derives income from a corporation in Estonia in which it holds 80 percent of the shares, and unrelated parties hold the remaining shares, for purposes of subparagraph 3(c) only 80 percent of the assets, payroll and gross income of the company in Estonia would be taken into account.

Consequently, if neither the recipient nor a person related to the recipient has an ownership interest in the person from whom the income is derived, the substantiality test always will be satisfied (the denominator in the computation of each ratio will be zero and the numerator will be a positive number). Of course, the other two prongs of the test under paragraph 3 would have to be satisfied in order for the recipient of the item of income to receive treaty benefits with respect to that income. For example, assume that a resident of Estonia is in the business of banking in Estonia. The bank loans money to unrelated residents of the United States. The bank would satisfy the substantiality requirement of this subparagraph with respect to interest paid on the loans because it has no ownership interest in the payors.

Paragraph 4

Paragraph 4 provides that a resident of one of the States that is not otherwise entitled to the benefits of the Convention may be granted benefits with respect to income arising in the other Contracting State under the Convention if the competent authority of the State from which benefits are claimed so determines. This discretionary provision is included in recognition of the fact that, with the increasing scope and diversity of international economic relations, there may be cases where significant participation by third country residents in an enterprise of a Contracting State is warranted by sound business practice or long-standing business structures and does not necessarily indicate a motive of attempting to derive unintended Convention benefits.

The competent authority of a State will base a determination under this paragraph on whether the establishment, acquisition, or maintenance of the person seeking benefits under the Convention, or the conduct of such person's operations, has or had as one of its principal purposes the obtaining of benefits under the Convention. Thus, persons that establish operations in one of the States with the principal purpose of obtaining the benefits of the Convention ordinarily will not be granted relief under paragraph 4.

The competent authority may determine to grant all benefits of the Convention, or it may determine to grant only certain benefits. For instance, it may determine to grant benefits only with respect to a particular item of income in a manner similar to paragraph 3. Further, the competent authority may set time limits on the duration of any relief granted.

It is assumed that, for purposes of implementing paragraph 4, a taxpayer will not be required to wait until the tax authorities of one of the States have determined that benefits are denied before he will be permitted to seek a determination under this paragraph. In these circumstances, it is also expected that if the competent authority determines that benefits are to be allowed, they will be allowed retroactively to the time of entry into force of the relevant treaty provision or the establishment of the structure in question, whichever is later.

Paragraph 5

Paragraph 5 provides that the term "recognized stock exchange" means (a) in the United States, the NASDAQ System owned by the National Association of Securities Dealers, and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934; and (b) in Estonia, the National Stock Exchange of Estonia (Nacionaline vertybinu popieriu birza), and any other stock exchanges approved by the State Authorities. In addition, subparagraph (c) of paragraph 5 provides for the competent authorities to agree upon any other recognized stock exchanges. Other exchanges, including exchanges located in third countries, may be recognized for this purpose by agreement of the competent authorities.

Paragraph 6

Paragraph 6 provides additional authority to the competent authorities (in addition to that of Article 25 (Mutual Agreement Procedure)) to consult together to develop a common application of the provisions of this Article, including the publication of regulations or other public guidance. The competent authorities shall, in accordance with the provisions of Article 26 (Exchange of Information and Administrative Assistance) exchange such information as is necessary to carry out the provisions of the Article.

ARTICLE 23 (RELIEF FROM DOUBLE TAXATION)

This Article describes the manner in which each Contracting State undertakes to relieve double taxation. The United States uses the foreign tax credit method both under internal law, and by treaty. Under Estonian law, Estonia uses a foreign tax credit for purposes both of the enterprise tax and the personal income tax. Under Article 23 Estonia allows a credit for both taxes.

Paragraph 1

The United States agrees, in paragraph 1, to allow to its citizens and residents a credit against U.S. tax for income taxes paid or accrued to Estonia. Paragraph 1(a), by referring to “Estonian tax”, which is the term used in Article 2 (Taxes Covered) to describe Estonia’s taxes covered, also makes clear that Estonia’s covered taxes are to be treated as income taxes under Article 23, for U.S. foreign tax credit purposes. The provision of a credit for these taxes is based on the Treasury Department’s review of Estonia’s laws.

The credit under the Convention is allowed in accordance with the provisions and subject to the limitations of U.S. law, as that law may be amended over time, so long as the general principle of this Article (*i.e.*, the allowance of a credit) is retained. Thus, although the Convention provides for a foreign tax credit, the terms of the credit are determined by the provisions, at the time a credit is given, of the U.S. statutory credit.

As indicated, the U.S. credit under the Convention is subject to the various limitations of U.S. law (*see* Code sections 901 - 908). For example, the credit against U.S. tax generally is limited to the amount of U.S. tax due with respect to net foreign source income within the relevant foreign tax credit limitation category (*see* Code section 904(a) and (d)), and the dollar amount of the credit is determined in accordance with U.S. currency translation rules (*see, e.g.*, Code section 986). Similarly, U.S. law applies to determine carryover periods for excess credits and other inter-year adjustments. When the alternative minimum tax is due, the alternative minimum tax foreign tax credit generally is limited in accordance with U.S. law to 90 percent of alternative minimum tax liability. Furthermore, nothing in the Convention prevents the limitation of the U.S. credit from being applied on a per-country basis (should internal law be changed), an overall basis, or to particular categories of income (*see, e.g.*, Code section 865(h)).

Subparagraph (b) provides for a deemed-paid credit, consistent with section 902 of the Code, to a U.S. corporation in respect of dividends received from an Estonian corporation, of which the U.S. corporation owns at least 10 percent of the voting stock. This credit is for the tax paid by the Estonian corporation on the profits out of which the dividends are considered paid.

Paragraph 2

Paragraph 2 contains the rules under which Estonia will avoid double taxation under the Convention. Under subparagraph (a) of this paragraph, Estonia agrees to allow a credit to a resident of Estonia deriving income from the United States for United States tax paid (as defined in subparagraph 1(a) of Article 2), to the extent it is paid in accordance with the Convention. The credit is for the full amount of United States tax, but not to exceed the Estonian tax on that income. The provision does not apply with respect to United States tax imposed on a resident of Estonia by reason of that person's U.S. citizenship, under the saving clause in paragraph 4 of Article 1 (General Scope). The paragraph also specifies that, consistent with paragraph 2 of Article 1, if a more favorable treatment is provided under Estonian law, that treatment will take precedence over the credit provided in the Convention.

Subparagraph (b) provides for a deemed-paid credit to an Estonian corporation in respect of dividends received from a corporation resident in the United States of which the Estonian corporation controls, directly or indirectly, at least 10 percent of the voting power. This credit is for the tax paid by the U.S. corporation on the profits out of which the dividends are paid, in addition to the U.S. tax paid by the Estonian corporation on the dividend itself.

Paragraph 3

For the purposes of allowing relief from double taxation pursuant to this Article, income derived by a resident of a Contracting State which may be taxed in the other Contracting State in accordance with this Convention (other than solely by reason of citizenship in accordance with paragraph 4 of Article 1 (General Scope)) shall be deemed to arise in that other State. Except as provided in Article 13 (Capital Gains), the preceding sentence is subject to such source rules in the domestic laws of the Contracting States as apply for purposes of limiting the foreign tax credit.

Relation to other Articles

By virtue of the exceptions in subparagraph 5(a) of Article 1 (General Scope), this Article is not subject to the saving clause of paragraph 4 of Article 1. Thus, the United States will allow a credit to its citizens and residents in accordance with the Article, even if such credit were to provide a benefit not available under the Code.

ARTICLE 24 (NONDISCRIMINATION)

This Article assures that nationals of a Contracting State, in the case of paragraph 1, and residents of a Contracting State, in the case of paragraphs 2 through 4, will not be subject, directly or indirectly, to discriminatory taxation in the other Contracting State. For this purpose, nondiscrimination means providing national treatment. Not all differences in tax treatment, either as between nationals of the two States, or between residents of the two States, are violations of this national treatment standard. Rather, the national treatment obligation of this Article applies only if the nationals or residents of the two States are comparably situated.

Each of the relevant paragraphs of the Article provides that two persons that are comparably situated must be treated similarly. Although the actual words differ from paragraph to paragraph (e.g., paragraph 1 refer to two persons "in the same circumstances," paragraph 2 refers to two enterprises "carrying on the same activities" and paragraph 4 refers to two enterprises that are "similar"), the common underlying premise is that if the difference in treatment is directly related to a tax-relevant difference in the situations of the domestic and foreign persons being compared, that difference is not to be treated as discriminatory (e.g., if one person is taxable in a Contracting State on worldwide income and the other is not, or if tax may be collectible from one person at a later stage, but not from the other, distinctions in treatment would be justified under paragraph 1). Other examples of such factors that can lead to non-discriminatory differences in treatment will be noted in the discussions of each paragraph.

The operative paragraphs of the Article also use different language to identify the kinds of differences in taxation treatment that will be considered discriminatory. For example, paragraphs 1 and 4 speak of "any taxation or any requirement connected therewith that is other or more burdensome," while paragraph 2 specifies that a tax "shall not be less favorably levied." Regardless of these differences in language, only differences in tax treatment that materially disadvantage the foreign person relative to the domestic person are properly the subject of the Article.

Paragraph 1

Paragraph 1 provides that a national of one Contracting State may not be subject to taxation or connected requirements in the other Contracting State that are different from, or more burdensome than, the taxes and connected requirements imposed upon a national of that other State in the same circumstances. As noted above, whether or not the two persons are both taxable on worldwide income is a significant circumstance for this purpose. Although, like the OECD Model, the text refers to "residence" rather than to "taxation on worldwide income," as a relevant circumstance, since, for most countries, worldwide taxation is based on residence, while in the United States it is based on citizenship, the intent of both approaches is clearly the same. This is confirmed by the last sentence of the paragraph, which states that the United States is not required to apply the same taxing regime to a national of Estonia who is not resident in the United

States and a U.S. national who is not resident in the United States. United States citizens who are not residents of the United States but who are, nevertheless, subject to United States tax on their worldwide income are not in the same circumstances with respect to United States taxation as citizens of Estonia who are not United States residents. Thus, for example, Article 24 would not entitle a national of Estonia resident in a third country to taxation at graduated rates on U.S. source dividends or other investment income that applies to a U.S. citizen resident in the same third country.

A national of a Contracting State is afforded protection under this paragraph even if the national is not a resident of either Contracting State. Thus, a U.S. citizen who is resident in a third country is entitled, under this paragraph, to the same treatment in Estonia as a citizen of Estonia who is in similar circumstances (*i.e.*, who is resident in a third State). The term "national" in relation to a Contracting State is defined in subparagraph 1(i) of Article 3 (General Definitions). The term includes both individuals and juridical persons.

Paragraph 2

Paragraph 2 of the Article provides that a Contracting State may not tax a permanent establishment of an enterprise of the other Contracting State, or a fixed base of an individual resident of the other State, less favorably than an enterprise or individual resident of that first-mentioned State that is carrying on the same activities. This provision, however, does not obligate a Contracting State to grant to a resident of the other Contracting State any tax allowances, reliefs, etc., that it grants to its own residents on account of their civil status or family responsibilities. Thus, if a sole proprietor who is a resident of Estonia has a permanent establishment in the United States, in assessing income tax on the profits attributable to the permanent establishment, the United States is not obligated to allow to the resident of Estonia the personal allowances for himself and his family that he would be permitted to take if the permanent establishment were a sole proprietorship owned and operated by a U.S. resident, despite the fact that the individual income tax rates would apply. Business related expenses, however, must be allowed as deductions to the Estonian resident to the same extent that they would be allowed to a U.S. resident.

The fact that a U.S. permanent establishment of a Estonian enterprise is subject to U.S. tax only on income that is attributable to the permanent establishment, while a U.S. corporation engaged in the same activities is taxable on its worldwide income is not, in itself, a sufficient difference to deny national treatment to the permanent establishment. There are cases, however, where the two enterprises would not be similarly situated and differences in treatment may be warranted. For instance, it would not be a violation of the nondiscrimination protection of paragraph 2 to require the Estonian enterprise to provide information in a reasonable manner that may be different from the information requirements imposed on a resident enterprise, because information may not be as readily available to the Internal Revenue Service from a foreign as from a domestic enterprise. Similarly, it would not be a violation of paragraph 2 to impose penalties on persons who fail to comply with such a requirement (*see, e.g.*, sections 874(a) and 882(c)(2)).

Further, a determination that income and expenses have been attributed or allocated to a permanent establishment in conformity with the principles of Article 7 (Business Profits) implies that the attribution or allocation was not discriminatory.

Section 1446 of the Code imposes on any partnership with income that is effectively connected with a U.S. trade or business the obligation to withhold tax on amounts allocable to a foreign partner. In the context of this Convention, this obligation applies with respect to a share of the partnership income of a partner resident in Estonia, and attributable to a U.S. permanent establishment. There is no similar obligation with respect to the distributive shares of U.S. resident partners. It is understood, however, that this distinction is not a form of discrimination within the meaning of paragraph 2 of the Article. No distinction is made between U.S. and non-U.S. partnerships, since the law requires that partnerships of both U.S. and non-U.S. domicile withhold tax in respect of the partnership shares of non-U.S. partners. Furthermore, in distinguishing between U.S. and non-U.S. partners, the requirement to withhold on the non-U.S. but not the U.S. partner's share is not discriminatory taxation, but, like other withholding on nonresident aliens, is merely a reasonable method for the collection of tax from persons who are not continually present in the United States, and as to whom it otherwise may be difficult for the United States to enforce its tax jurisdiction. If tax has been over-withheld, the partner can, as in other cases of over-withholding, file for a refund. (The relationship between paragraph 2 and the imposition of the branch tax is dealt with below in the discussion of paragraph 5.)

Paragraph 2 obligates the host State to provide national treatment not only to permanent establishments of an enterprise of the other Contracting State, but also to other residents of that State that are taxable in the host State on a net basis because they derive income from independent personal services performed in the host State that is attributable to a fixed base in that State. Thus, an individual resident of Estonia who performs independent personal services in the United States, and who is subject to U.S. income tax on the income from those services that is attributable to a fixed base in the United States, is entitled to no less favorable tax treatment in the United States than a U.S. resident engaged in the same kinds of activities. With such a rule in a treaty, the host State cannot tax its own residents on a net basis, but disallow deductions (other than personal allowances, etc.) of a resident in the other Contracting State with respect to the income attributable to the fixed base. Similarly, in accordance with paragraph 6 of Article 6 (Income from Immovable (Real) Property), the situs State would be required to allow deductions to a resident of the other State with respect to income derived from real property located in the situs State to the same extent that deductions are allowed to residents of the situs State with respect to income derived from real property located in the situs State.

Paragraph 3

Paragraph 3 prohibits discrimination in the allowance of deductions. When an enterprise of a Contracting State pays interest, royalties or other disbursements to a resident of the other Contracting State, the first-mentioned Contracting State must allow a deduction for those payments in computing the taxable profits of the enterprise as if the payment had been made under

the same conditions to a resident of the first-mentioned Contracting State. An exception to this rule is provided for cases where the provisions of paragraph 1 of Article 9 (Associated Enterprises), paragraph 7 of Article 11 (Interest) or paragraph 5 of Article 12 (Royalties) apply, because in these situations, the related parties have entered into transactions on a non-arms-length basis. This exception would include the denial or deferral of certain interest deductions under Code section 163(j).

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.

Paragraph 3 also provides that any debts of an enterprise of a Contracting State to a resident of the other Contracting State are deductible in the first-mentioned Contracting State for computing the capital tax of the enterprise under the same conditions as if the debt had been contracted to a resident of the first-mentioned Contracting State. Even though, for general purposes, the Convention covers only income taxes, under paragraph 6 of this Article, the nondiscrimination provisions apply to all taxes levied in both Contracting States, at all levels of government. Thus, this provision may be relevant for both States. Estonia does impose property tax, and in the United States such taxes are imposed by local governments.

Paragraph 4

Paragraph 4 requires that a Contracting State not impose other or more burdensome taxation or connected requirements on an enterprise of that State that is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, than the taxation or connected requirements that it imposes on other similar enterprises of that first-mentioned Contracting State. For this purpose it is understood that "similar" refers to similar activities or ownership of the enterprise.

This rule, like all non-discrimination provisions, does not prohibit differing treatment of entities that are in differing circumstances. Rather, a protected enterprise is only required to be treated in the same manner as other enterprises that, from the point of view of the application of the tax law, are in substantially similar circumstances both in law and in fact. The taxation of a distributing corporation under section 367(e) on an applicable distribution to foreign shareholders does not violate paragraph 4 of the Article because a foreign-owned corporation is not similar to a domestically-owned corporation that is accorded nonrecognition treatment under sections 337 and 355.

For the reasons given above in connection with the discussion of paragraph 2 of the Article, it is also understood that the provision in section 1446 of the Code for withholding of tax on non-U.S. partners does not violate paragraph 4 of the Article.

It is further understood that the ineligibility of a U.S. corporation with nonresident alien shareholders to make an election to be an "S" corporation does not violate paragraph 4 of the Article. If a corporation elects to be an S corporation (requiring 5 or fewer shareholders), it is generally not subject to income tax and the shareholders take into account their pro rata shares of the corporation's items of income, loss, deduction or credit. (The purpose of the provision is to allow an individual or small group of individuals to conduct business in corporate form while paying taxes at individual rates as if the business were conducted directly.) A nonresident alien does not pay U.S. tax on a net basis, and, thus, does not generally take into account items of loss, deduction or credit. Thus, the S corporation provisions do not exclude corporations with nonresident alien shareholders because such shareholders are foreign, but only because they are not net-basis taxpayers. Similarly, the provisions exclude corporations with other types of shareholders where the purpose of the provisions cannot be fulfilled or their mechanics implemented. For example, corporations with corporate shareholders are excluded because the purpose of the provisions to permit individuals to conduct a business in corporate form at individual tax rates would not be furthered by their inclusion.

Paragraph 5

Paragraph 5 of the Article confirms that no provision of the Article will prevent either Contracting State from imposing the branch tax described in paragraph 5 of Article 10 (Dividends). Since imposition of the branch tax under the Model Convention is specifically sanctioned by paragraph 5 of Article 10 (Dividends), its imposition could not be precluded by Article 24, even without paragraph 5. Under the generally accepted rule of construction that the specific takes precedence over the more general, the specific branch tax provision of Article 10 would take precedence over the more general national treatment provision of Article 25. For that reason, the fact that there is no reference in paragraph 5 to the branch level interest tax authorized under paragraph 8 of Article 11 (Interest) does not preclude the imposition of the branch level interest tax. Furthermore, IRS Notice 89-80 states clearly that the branch level interest tax does not conflict with the non-discrimination provisions of any U.S. treaties.

Paragraph 6

As noted above, notwithstanding the specification in Article 2 (Taxes Covered) of taxes covered by the Convention for general purposes, for purposes of providing nondiscrimination protection this Article applies to taxes of every kind and description imposed by a Contracting State or a political subdivision or local authority thereof. Customs duties are not considered to be taxes for this purpose.

Relation to Other Articles

The saving clause of paragraph 4 of Article 1 (General Scope) does not apply to this Article, by virtue of the exceptions in paragraph 5(a) of Article 1. Thus, for example, a U.S. citizen who is a resident of Estonia may claim benefits from the United States under this Article.

Nationals of a Contracting State may claim the benefits of paragraph 1 regardless of whether they are entitled to benefits under Article 22 (Limitation on Benefits), because that paragraph applies to nationals and not residents. They may not claim the benefits of the other paragraphs of this Article with respect to an item of income unless they are generally entitled to treaty benefits with respect to that income under a provision of Article 22.

ARTICLE 25 (MUTUAL AGREEMENT PROCEDURE)

This Article provides the mechanism for taxpayers to bring to the attention of the Contracting States' competent authorities issues and problems that may arise under the Convention. It also provides a mechanism for cooperation between the competent authorities of the Contracting States to resolve disputes and clarify issues that may arise under the Convention and to resolve cases of double taxation not provided for in the Convention. The competent authorities of the two Contracting States are identified in paragraph 1(h) of Article 3 (General Definitions).

Paragraph 1

This paragraph provides that where a resident of a Contracting State considers that the actions of one or both Contracting States will result in taxation that is not in accordance with the Convention he may present his case to the competent authority of either Contracting State. Allowing a person to bring a case to either competent authority follows the U.S. Model provision, which is based on paragraph 16 of the Commentaries to Article 25 of the OECD Model, which suggests that countries may agree to allow a case to be brought to either competent authority. There is no apparent reason why a resident of a Contracting State must take its case to the competent authority of its State of residence and not to that of the partner. Under this approach, for example, a U.S. permanent establishment of a corporation resident in Estonia that faces inconsistent treatment in the two countries would be able to bring its complaint to the competent authority in either Contracting State.

Although the typical cases brought under this paragraph will involve economic double taxation arising from transfer pricing adjustments, the scope of this paragraph is not limited to such cases. For example, if a Contracting State treats income derived by a company resident in the other Contracting State as attributable to a permanent establishment in the first-mentioned Contracting State, and the resident believes that the income is not attributable to a permanent establishment, or that no permanent establishment exists, the resident may bring a complaint under paragraph 1 to the competent authority of either Contracting State.

It is not necessary for a person bringing a complaint first to have exhausted the remedies provided under the national laws of the Contracting States before presenting a case to the competent authorities, nor does the fact that the statute of limitations may have passed for seeking a refund preclude bringing a case to the competent authority.

Unlike the U.S. Model, but like the OECD Model, paragraph 1 provides that a case must be presented to a competent authority within three years of the first notification of the action giving rise to taxation not in accordance with the provisions of the Convention. Paragraph 18 of the Commentaries to the OECD Model states that identifying the date of the first notification, as referred to in paragraph 1, should be done in a manner most favorable to the taxpayer. For

example, if an action results from the tax authority following a published procedure, the first notification would not be the date of publication of the procedure, but rather the date on which the taxpayer was first notified of the decision to apply the procedure to him.

Paragraph 2

This paragraph instructs the competent authorities in dealing with cases brought by taxpayers under paragraph 1. It provides that if the competent authority of the Contracting State to which the case is presented judges the case to have merit, and cannot reach a unilateral solution, it shall seek an agreement with the competent authority of the other Contracting State pursuant to which taxation not in accordance with the Convention will be avoided. During the period that a proceeding under this Article is pending, any assessment and collection procedures should be suspended. Any agreement is to be implemented even if such implementation otherwise would be barred by the statute of limitations or by some other procedural limitation, such as a closing agreement. In a case where the taxpayer has entered a closing agreement (or other written settlement) with the United States prior to bringing a case to the competent authorities, the U.S. competent authority will endeavor only to obtain a correlative adjustment from Estonia and will not take any action that would otherwise change such agreements. See, Rev. Proc. 96-13, 1996-3 I.R.B. 31, section 7.05. Because, as specified in paragraph 2 of Article 1 (General Scope), the Convention cannot operate to increase a taxpayer's liability, time or other procedural limitations can be overridden only for the purpose of making refunds and not to impose additional tax.

Paragraph 3

Paragraph 3 authorizes the competent authorities to resolve difficulties or doubts that may arise as to the application or interpretation of the Convention. The paragraph includes a non-exhaustive list of examples of the kinds of matters about which the competent authorities may reach agreement. This list is purely illustrative; with the exception of subparagraph (g) it does not grant any authority that is not implicitly present as a result of the introductory sentence of paragraph 3. The competent authorities may, for example, agree to the same attribution of income, deductions, credits or allowances between an enterprise in one Contracting State and its permanent establishment in the other (subparagraph (a)) or between related persons (subparagraph (b)). These allocations are to be made in accordance with the arm's length principle underlying Article 7 (Business Profits) and Article 9 (Associated Enterprises). Agreements reached under these subparagraphs may include agreement on a methodology for determining an appropriate transfer price, common treatment of a taxpayer's cost sharing arrangement, or upon an acceptable range of results under that methodology. Subparagraph (h) makes clear that they may also agree to apply this methodology and range of results prospectively to future transactions and time periods pursuant to advance pricing agreements ("APA"s). The use of an APA by a Contracting State does not require that there be a bilateral agreement.

As indicated in subparagraphs (c), (d), (e) and (f), the competent authorities also may agree to settle a variety of conflicting applications of the Convention. They may agree to characterize particular items of income in the same way (subparagraph (c)), to characterize entities in a particular way (subparagraph (d)), to apply the same source rules to particular items of income (subparagraph (e)), and to adopt a common meaning of a term (subparagraph f)).

Subparagraph (g) authorizes the competent authorities to increase any dollar amounts referred to in the Convention to reflect economic and monetary developments. This provision could apply to Article 17 (Artistes and Sportsmen), or to Article 20 (Students, Trainees and Researchers). The rule under paragraph 4 is intended to operate as follows: if, for example, after the Convention has been in force for some time, inflation rates have been such as to make the \$20,000 exemption threshold under Article 17 for entertainers unrealistically low in terms of the original objectives intended in setting the threshold, the competent authorities may agree to a higher threshold without the need for formal amendment to the treaty and ratification by the Contracting States. This authority can be exercised, however, only to the extent necessary to restore those original objectives. Because of paragraph 2 of Article 1 (General Scope), it is clear that this provision can be applied only to the benefit of taxpayers, *i.e.*, only to increase thresholds, not to reduce them.

Subparagraph (h) makes clear that the competent authorities can agree to the common application, consistent with the objective of avoiding double taxation, of procedural provisions of the internal laws of the Contracting States, including those regarding penalties, fines and interest.

Since the list under paragraph 3 is not exhaustive, the competent authorities may reach agreement on issues not enumerated in paragraph 3 if necessary to avoid double taxation. For example, the competent authorities may seek agreement on a uniform set of standards for the use of exchange rates, or agree on consistent timing of gain recognition with respect to a transaction to the extent necessary to avoid double taxation. Agreements reached by the competent authorities under paragraph 3 need not conform to the internal law provisions of either Contracting State.

Finally, paragraph 3 authorizes the competent authorities to consult for the purpose of eliminating double taxation in cases not provided for in the Convention and to resolve any difficulties or doubts arising as to the interpretation or application of the Convention. This provision is intended to permit the competent authorities to implement the treaty in particular cases in a manner that is consistent with its expressed general purposes. It permits the competent authorities to deal with cases that are within the spirit of the provisions but that are not specifically covered. An example of such a case might be double taxation arising from a transfer pricing adjustment between two permanent establishments of a third-country resident, one in the United States and one in Estonia. Since no resident of a Contracting State is involved in the case, the Convention does not apply, but the competent authorities nevertheless may use the authority of the Convention to prevent the double taxation.

Paragraph 4

Paragraph 4 provides that the competent authorities may communicate with each other for the purpose of reaching an agreement. This makes clear that the competent authorities of the two Contracting States may communicate without going through diplomatic channels. Such communication may be in various forms, including, where appropriate, through face-to-face meetings of the competent authorities or their representatives.

Other Issues

Treaty effective dates and termination in relation to competent authority dispute resolution

A case may be raised by a taxpayer under a treaty with respect to a year for which a treaty was in force after the treaty has been terminated. In such a case the ability of the competent authorities to act is limited. They may not exchange confidential information, nor may they reach a solution that varies from that specified in its law.

A case also may be brought to a competent authority under a treaty that is in force, but with respect to a year prior to the entry into force of the treaty. The scope of the competent authorities to address such a case is not constrained by the fact that the treaty was not in force when the transactions at issue occurred, and the competent authorities have available to them the full range of remedies afforded under this Article.

Triangular competent authority solutions

International tax cases may involve more than two taxing jurisdictions (e.g., transactions among a parent corporation resident in country A and its subsidiaries resident in countries B and C). As long as there is a complete network of treaties among the three countries, it should be possible, under the full combination of bilateral authorities, for the competent authorities of the three States to work together on a three-sided solution. Although country A may not be able to give information received under Article 26 (Exchange of Information and Administrative Assistance) from country B to the authorities of country C, if the competent authorities of the three countries are working together, it should not be a problem for them to arrange for the authorities of country B to give the necessary information directly to the tax authorities of country C, as well as to those of country A. Each bilateral part of the trilateral solution must, of course, not exceed the scope of the authority of the competent authorities under the relevant bilateral treaty.

Relation to Other Articles

This Article is not subject to the saving clause of paragraph 4 of Article 1 (General Scope) by virtue of the exceptions in paragraph 5(a) of 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. Similarly, as indicated above, U.S. law may be overridden to provide refunds of tax to a U.S. citizen or resident under this Article. A person may seek relief under Article 25 regardless of whether he is generally entitled to benefits under Article 22 (Limitation on Benefits). As in all other cases, the competent authority is vested with the discretion to decide whether the claim for relief is justified.

ARTICLE 26 (EXCHANGE OF INFORMATION AND ADMINISTRATIVE ASSISTANCE)

Paragraph 1

This Article provides for the exchange of information between the competent authorities of the Contracting States. The information to be exchanged is that which is relevant for carrying out the provisions of the Convention or the domestic laws of the United States or Estonia concerning the taxes covered by the Convention.

The taxes covered by the Convention for purposes of this Article constitute a broader category of taxes than those referred to in Article 2 (Taxes Covered). As provided in paragraph 6, for purposes of exchange of information, covered taxes include all taxes imposed by the Contracting States. Exchange of information with respect to domestic law is authorized insofar as the taxation under those domestic laws is not contrary to the Convention. Thus, for example, information may be exchanged with respect to a covered tax, even if the transaction to which the information relates is a purely domestic transaction in the requesting State and, therefore, the exchange is not made for the purpose of carrying out the Convention.

An example of such a case is provided in the OECD Commentary: A company resident in the United States and a company resident in Estonia transact business between themselves through a third-country resident company. Neither Contracting State has a treaty with the third State. In order to enforce their internal laws with respect to transactions of their residents with the third-country company (since there is no relevant treaty in force), the Contracting State may exchange information regarding the prices that their residents paid in their transactions with the third-country resident.

Paragraph 1 states that information exchange is not restricted by Article 1 (General Scope). Accordingly, information may be requested and provided under this Article with respect to persons who are not residents of either Contracting State. For example, if a third-country resident has a permanent establishment in Estonia which engages in transactions with a U.S. enterprise, the United States could request information with respect to that permanent establishment, even though it is not a resident of either Contracting State. Similarly, if a third-country resident maintains a bank account in Estonia, and the Internal Revenue Service has reason to believe that funds in that account should have been reported for U.S. tax purposes but have not been so reported, information can be requested from Estonia with respect to that person's account.

Paragraph 1 also provides assurances that any information exchanged will be treated as secret, subject to the same disclosure constraints as information obtained under the laws of the requesting State. Information received may be disclosed only to persons, including courts and administrative bodies, included with the assessment, collection, enforcement or prosecution in respect of the taxes to which the information relates, or to persons concerned with the

administration of these taxes or the oversight of such activities. The information must be used by these persons in connection with these designated functions. Persons in the United States involved with oversight of the administration of taxes include legislative bodies, such as the tax-writing committees of Congress and the General Accounting Office. Information received by these bodies must be for use in the performance of their role in overseeing the administration of U.S. tax laws. Information received may be disclosed in public court proceedings or in judicial decisions.

The Article authorizes the competent authorities to exchange information on a routine basis, on request in relation to a specific case, or spontaneously. It is contemplated that the Contracting States will utilize this authority to engage in all of these forms of information exchange, as appropriate.

Paragraph 2

Paragraph 2 provides that the obligations undertaken in paragraph 1 to exchange information do not require a Contracting State to carry out administrative measures that are at variance with the laws or administrative practice of either State. Nor is a Contracting State required to supply information not obtainable under the laws or administrative practice of either State, or to disclose trade secrets or other information, the disclosure of which would be contrary to public policy. Thus, a requesting State may be denied information from the other State if the information would be obtained pursuant to procedures or measures that are broader than those available in the requesting State.

While paragraph 2 states conditions under which a Contracting State is not obligated to comply with a request from the other Contracting State for information, the requested State is not precluded from providing such information, and may, at its discretion, do so subject to the limitations of its internal law.

Paragraph 3

Paragraph 3 sets forth two exceptions from the dispensations described in paragraph 2. First, the paragraph provides that a Contracting State, shall, upon request of the other Contracting State, have the authority to obtain, and provide, information held by financial institutions, nominees or persons acting in a fiduciary capacity. It shall also have the authority to obtain information respecting ownership of debt instruments or interests in a person. Such information must be provided to the requesting State notwithstanding any laws or practices of the requested State that would otherwise preclude acquiring or disclosing such information

Second, paragraph 3 provides that when information is requested by a Contracting State in accordance with this Article, the other Contracting State is obligated to obtain the requested information as if the tax in question were the tax of the requested State, even if that State has no direct tax interest in the case to which the request relates.

Paragraph 3 further provides that the requesting State may specify the form in which information is to be provided (e.g., depositions of witnesses and authenticated copies of original documents) so that the information is usable in the judicial proceedings of the requesting State. The requested State should, if possible, provide the information in the form requested to the same extent that it can obtain information in that form under its own laws and administrative practices with respect to its own taxes.

Paragraph 4

Paragraph 4 provides for assistance in collection of taxes to the extent necessary to ensure that treaty benefits are enjoyed only by persons entitled to those benefits under the terms of the Convention. Under paragraph 4, a Contracting State will endeavor to collect on behalf of the other State only those amounts necessary to ensure that any exemption or reduced rate of tax at source granted under the Convention by that other State is not enjoyed by persons not entitled to those benefits. For example, if a U.S. source dividend is paid to an addressee in Estonia, the withholding agent under current rules may withhold at the treaty's portfolio dividend rate of 15 percent. If, however, the addressee is merely acting as a nominee on behalf of a third-country resident, paragraph 4 would obligate Estonia to withhold and remit to the United States the additional tax that should have been collected by the U.S. withholding agent.

Paragraph 5

Paragraph 5 makes clear that the Contracting State asked to collect the tax under paragraph 4 is not obligated, in the process of providing collection assistance, to carry out administrative measures that are different from those used in the collection of its own taxes, or that would be contrary to its sovereignty, security or public policy.

Paragraph 6

As noted above in the discussion of paragraph 1, the exchange of information provisions of the Convention apply to all taxes imposed by a Contracting State, not just to those taxes designated as covered taxes under Article 2 (Taxes Covered). The U.S. competent authority may, therefore, request information for purposes of, for example, estate and gift taxes or federal excise taxes.

Paragraph 7

Finally, paragraph 7 provides that the competent authority of the requested State shall allow representatives of the applicant State to enter the requested State to interview individuals and examine books and records with the consent of the persons subject to examination and in the presence of the competent authority of the requested state.

Treaty effective dates and termination in relation to information exchange

A tax administration may seek information with respect to a year for which a treaty was in force after the treaty has been terminated. In such a case the ability of the other tax administration to act is limited. The treaty no longer provides authority for the tax administrations to exchange confidential information. They may only exchange information that can be made available pursuant to domestic law.

The competent authority also may seek information under a treaty that is in force, but with respect to a year prior to the entry into force of the treaty. The scope of the competent authorities to address such a case is not constrained by the fact that a treaty was not in force when the transactions at issue occurred, and the competent authorities have available to them the full range of information exchange provisions afforded under this Article.

ARTICLE 27 (MEMBERS OF DIPLOMATIC MISSIONS AND CONSULAR POSTS)

This Article confirms that any fiscal privileges to which members of diplomatic missions or consular posts are entitled under general provisions of international law or under special agreements will apply notwithstanding any provisions to the contrary in the Convention. The agreements referred to include any bilateral agreements, such as consular conventions, that affect the taxation of diplomats and consular officials and any multilateral agreements dealing with these issues, such as the Vienna Convention on Diplomatic Relations and the Vienna Convention on Consular Relations. The United States generally adheres to the latter because its terms are consistent with customary international law.

The Article does not independently provide any benefits to diplomatic agents and consular officers. Article 19 (Government Service) does so, as do Code section 893 and a number of bilateral and multilateral agreements. In the event that there is a conflict between the tax treaty and international law or such other treaties, under which the diplomatic agent or consular official is entitled to greater benefits under the latter, the latter laws or agreements shall have precedence. Conversely, if the tax treaty confers a greater benefit than another agreement, the affected person could claim the benefit of the tax treaty.

Pursuant to subparagraph 5(b) of Article 1, the saving clause of paragraph 4 of Article 1 (General Scope) does not apply to override any benefits of this Article available to an individual who is neither a citizen of the United States nor has immigrant status in the United States.

ARTICLE 28 (ENTRY INTO FORCE)

This Article contains the rules for bringing the Convention into force and giving effect to its provisions.

Paragraph 1

Paragraph 1 provides that each State must notify the other through diplomatic channels when its "constitutional requirements" for ratification have been complied with. The constitutional requirements include ratification.

In the United States, the process leading to ratification and entry into force is as follows: Once a treaty has been signed by authorized representatives of the two Contracting States, the Department of State sends the treaty to the President who formally transmits it to the Senate for its advice and consent to ratification, which requires approval by two-thirds of the Senators present and voting. Prior to this vote, however, it generally has been the practice for the Senate Committee on Foreign Relations to hold hearings on the treaty and make a recommendation regarding its approval to the full Senate. Both Government and private sector witnesses may testify at these hearings. After receiving the Senate's advice and consent to ratification, the treaty is returned to the President for his signature on the ratification document. The President's signature on the document completes the process in the United States.

Paragraph 2

Paragraph 2 provides that the Convention will enter into force on the date on which the second of the two notifications of the completion of ratification requirements has been received. The date on which the Convention enters into force is not the date on which its provisions take effect. Paragraph 2 contains rules that determine when the provisions of the treaty will have effect. Under paragraph 2(a), the Convention will have effect with respect to taxes withheld at source (principally dividends, interest and royalties) for amounts paid or credited on or after the first day of January of the calendar year next following the date on which the Convention enters into force. For example, if instruments of ratification are exchanged on September 15 of a given year, the withholding rates specified in paragraph 2 of Article 10 (Dividends) would be applicable to any dividends paid or credited on or after January 1 of the following year. If for some reason a withholding agent withholds at a higher rate than that provided by the Convention (perhaps because it was not able to re-program its computers before the payment is made), the beneficial owner of the income may make a claim for refund pursuant to Code section 1464.

For all other taxes, paragraph 2(b) specifies that the Convention will have effect for any taxable year or assessment period beginning on or after January 1 of the year following entry into force.

As discussed under Articles 25 (Mutual Agreement Procedure) and 26 (Exchange of Information and Administrative Assistance), the powers afforded the competent authority under these Articles may apply retroactively to taxable periods preceding entry into force.

Paragraph 3

Paragraph 3 provides that the appropriate authorities of the Contracting States will consult within 5 years from the date of the entry into force of the convention regarding the application of the Convention to income derived from “new technologies.” This term includes income from transmission by satellite, cable, optic fibre and similar technologies. These consultations may result in agreements by the competent authorities regarding the application of the existing agreement, or they may, if deemed appropriate, lead to amendments to the Convention by means of a protocol that would be subject to ratification. The “appropriate authorities” may be the Contracting States themselves or the competent authorities under the Convention.

Absent such agreement, under this Convention, income derived from these new technologies derived by a resident of one contracting State is not taxable in the other Contracting State unless such income is attributable to a permanent establishment in that other State. The principles of Article 5 (Permanent Establishment) will apply for purposes of determining whether a permanent establishment exists. If a permanent establishment does exist, the provisions of Article 7 (Business Profits) would apply to determine the amount of profits attributable to the permanent establishment that would be subject to tax in the host state.

ARTICLE 29 (TERMINATION)

The Convention is to remain in effect indefinitely, unless terminated by one of the Contracting States in accordance with the provisions of Article 30. The Convention may be terminated by either Contracting State at any time by giving written notice of termination through the diplomatic channel at least six months prior to the end of any calendar year. If notice of termination is given, the provisions of the Convention with respect to withholding at source will cease to have effect for amounts paid or credited on or after January first of the year following the year in which the notice of termination is given. For other taxes, the Convention will cease to have effect for taxable years beginning on or after January first of the year following the year in which the notice of termination is given.

A treaty performs certain specific and necessary functions regarding information exchange and mutual agreement. In the case of information exchange the treaty's function is to override confidentiality rules relating to taxpayer information. In the case of mutual agreement its function is to allow competent authorities to modify internal law in order to prevent double taxation and tax avoidance. With respect to the effective termination dates for these aspects of the treaty, therefore, if a treaty is terminated as of January 1 of a given year, no otherwise confidential information can be exchanged after that date, regardless of whether the treaty was in force for the taxable year to which the request relates. Similarly, no mutual agreement departing from internal law can be implemented after that date, regardless of the taxable year to which the agreement relates. Therefore, for the competent authorities to be allowed to exchange otherwise confidential information or to reach a mutual agreement that departs from internal law, a treaty must be in force at the time those actions are taken and any existing competent authority agreement ceases to apply.

Article 29 relates only to unilateral termination of the Convention by a Contracting State. Nothing in that Article should be construed as preventing the Contracting States from concluding a new bilateral agreement, subject to ratification, that supersedes, amends or terminates provisions of the Convention without the six-month notification period.

Customary international law observed by the United States and other countries, as reflected in the Vienna Convention on Treaties, allows termination by one Contracting State at any time in the event of a "material breach" of the agreement by the other Contracting State.