TREASURY DEPARTMENT TECHNICAL EXPLANATION OF THE CONVENTION AND PROTOCOL BETWEEN THE UNITED STATES OF AMERICA AND THE FEDERAL REPUBLIC OF GERMANY FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAPITAL AND TO CERTAIN OTHER TAXES SIGNED AT BONN ON AUGUST 29, 1989

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INTRODUCTION

This is a technical explanation of the Convention and Protocol between the United States and the Federal Republic of Germany signed on August 29, 1989 ("the Convention"). References are made to the Convention between the United States and the Federal Republic of Germany for the Avoidance of Double Taxation with Respect to Taxes on Income and to Certain other Taxes, signed on 22 July, 1954, as amended by the Protocol signed on 17 September, 1965 ("the 1954 Convention"). The Convention replaces the 1954 Convention. Negotiations took as their starting point the U.S. Treasury Department's draft Model Income Tax Convention, published on June 16, 1981 ("the U.S. Model"), the Model Double Taxation Convention on Income and Capital, published by the OECD in 1977 ("the OECD Model"), and an unpublished German model treaty.

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.

The explanations of each article will include explanations of any Protocol provisions relating to that article.

TABLE OF ARTICLES

ARTICLE 1
General Scope

Article 1 provides that the Convention is applicable to residents of the United States or the Federal Republic of Germany ("Germany") except where the terms of the Convention provide otherwise. Under Article 4 (Residence) a person is 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, subject to certain limitations, as described in Article 4. If, however, a person is, under those criteria, a resident of both Contracting States, a single state of residence (or no state of residence) is assigned under Article 4. This definition governs for all provisions of the Convention. Certain provisions are applicable to persons who may not be residents of either Contracting State. For example, Article 19 (Government Service; Social Security) may apply to a citizen of a Contracting State who is resident in neither. 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.

The provisions of paragraph 2 of Article 1 of the U.S. Model, describing the relationship between the rules of the Convention, on the one hand, and the laws of the Contracting States and other agreements between the Contracting States, on the other, and the provisions of paragraphs 3 and 4 of Article 1, preserving certain taxing rights of the Contracting States under the "saving clause", are found in Paragraph 1 of the Protocol. Although Paragraph 1 of the Protocol does not relate specifically to Article 1, its provisions are discussed here for ease of reference.

Subparagraphs (a) and (b) of Paragraph 1 of the Protocol contain the traditional saving clause. Unlike the similar provision in the U.S. Model, the saving clause in the Protocol is

unilateral, applying only for United States tax purposes. Under subparagraph (a), the United States reserves its right, except as provided in paragraph (b), to tax U.S. resident's and citizens as provided in the Internal Revenue Code ("Code"), notwithstanding any Convention provisions to the contrary. If, for example, a German resident 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 normally prevent the United States from taxing the income. If, however, the German 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. (For special foreign tax credit rules applicable to the U.S. taxation of certain U.S. income of its citizens resident in Germany, see paragraph 3 of Article 23 (Relief from Double Taxation).) "Residence", for the purpose of the saving clause, is determined under Article 4 (Residence). Thus; for example, 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 Germany under German law, and that individual has a permanent home available to him in Germany and not in the United States, he would be treated as a resident of Germany 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. Under paragraph (a), the United States also reserves its right to tax former U.S. citizens whose loss of citizenship had as one of its principal purposes the avoidance of U.S. income tax. Such a former citizen is taxable in accordance with the provisions of section 877 of the Code for 10 years following the loss of citizenship.

Subparagraph (b) sets forth certain exceptions to the saving clause in cases where its application would contravene policies reflected in the treaty which are intended to extend U.S. benefits to U.S. citizens and residents. Sub-subparagraph (b)(aa) lists certain provisions of the Convention which will be applicable to all U.S. citizens and residents despite the general saving clause rule of subparagraph (a):

(1) Paragraph 2 of Article 9 (Associated Enterprises) grants the right to a correlative adjustment, and, particularly, permits the override of the statute of limitations for the purpose of refunding tax under such a correlative adjustment.

(2) Paragraph 6 of Article 13 (Gains) provides special basis adjustment rules for U.S. taxation of gains derived by certain U.S. residents on the alienation of shares which represent a substantial holding in a German corporation. The rule coordinates U.S. and German taxation, and is intended to apply to U.S. citizens.

(3) Paragraphs 3 and 4 of Article 18 (Pensions, Annuities, Alimony and Child Support) deal with alimony and child support payments. Their inclusion in the exceptions to the saving clause means that alimony paid by a U.S. resident to a German resident who is a U.S. citizen will not be taxed by the United States as income of the U.S. citizen. Similarly, if a resident of Germany pays child support to a resident of the United States, the United States may not tax the recipient.

(4) Subparagraph 1(c) of Article 19 (Government Service; Social Security) provides that only the paying State may tax payments to a resident of the other which are compensation for injury or damage suffered as a result of hostility or persecution. This refers to German war reparations payments. The exception to the saving clause prohibits the United States from taxing such payments received by its residents and citizens even if they would otherwise be taxable under the Code.

(5) Paragraph 2 of Article 19 provides for the taxation of social security benefits only in the State of residence of the beneficiary. Excepting this rule from the saving clause means that the United States may not apply the Code rules to tax its citizens resident in Germany on U.S. social security benefits.

(6) Article 23 (Relief from Double Taxation) confers the benefit of a foreign tax credit on U.S. citizens and residents. To apply the saving clause to this Article would render the Article meaningless.

(7) Article 25 (Mutual Agreement Procedure) may confer benefits on U.S. citizens and residents. The statute of limitations may be waived for refunds, the competent authorities are permitted to use a definition of a term which differs from the Code definition, or they may refer an issue to an arbitration panel. As with the foreign tax credit, these benefits are intended to be granted by a Contracting State to its citizens and residents.

Sub-subparagraph (b)(bb) provides a different set of exceptions to the saving clause. The benefits referred to are all intended to be granted to temporary U.S. residents, but not to U.S. citizens and immigrants. If beneficiaries of these provisions come to the United States from Germany and remain in the United States long enough to become residents under the Code, but do not acquire immigrant status (i.e., they do not become "green card" holders) and are not citizens of the United States, the United States will continue to grant these benefits even if they conflict with the Code rules. The benefits preserved by this paragraph are the host country exemptions for the following items of income: Government service salaries and pensions under subparagraph 1(b) of Article 19 (Government Service; Social Security); certain income of visiting teachers, students and trainees under Article 20 (Visiting Professors and Teachers; Students and Trainees); and the income of diplomatic and consular officers under Article 30 (Members of Diplomatic Missions and Consular Posts).

Subparagraph (c) of Paragraph 1 of the Protocol is the same as paragraph 2 of Article 1 of the U.S. Model. It is also essentially the same as paragraph 2 of Article XVIII of the 1954 Convention. This paragraph makes explicit, on a reciprocal basis, the generally accepted principle that no provision in the Convention may restrict any exclusion, exemption, deduction, credit or other allowance accorded by the tax laws of the Contracting States. Thus, for example, if a deduction would be allowed under the Code in computing the taxable income of a resident of Germany, the deduction will be available to that person in computing income under the treaty. In no event may the treaty increase the tax burden on residents of the Contracting States. Thus, a right to tax given by the treaty cannot be exercised by the United States unless that right also exists under the Code.

A taxpayer may always rely on the more favorable Code treatment. This does not mean, however, that a taxpayer may pick and choose among Code and treaty provisions in an inconsistent manner in order to minimize tax. For example, assume a resident of Germany has three separate businesses in the United States. One is a profitable permanent establishment and the other two are trades or businesses which would earn taxable income under the Code but which 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 taxable. 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 C.B. 1984-1, 10.) If 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 which 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 Germany. For example, if certain benefits are provided for military personnel or military contractors under the Status of Forces Agreement, or if certain protection, not found in the Convention, is afforded under the Treaty of Friendship, Commerce and Navigation, or the Treaty of Friendship, Commerce and Consular Rights, 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.

Subparagraph (d) of Paragraph 1 of the Protocol contains a rule relating to German tax. In much the same way that the saving clause preserves U.S. taxing rights with respect to its citizens and residents, this paragraph preserves German statutory rights with respect to the income of German residents. It further provides that if any tax imposed by virtue of this paragraph results in double taxation, the competent authorities will seek to eliminate the double taxation by use of the mutual agreement procedure, particularly paragraph 3 of Article 25 (Mutual Agreement Procedure) which provides, among other things, for consultation between the competent authorities to eliminate double taxation in cases not provided for in the Convention.

ARTICLE 2
Taxes Covered

This Article identifies the U.S. and German taxes to which the Convention applies. These are referred to in the Convention as "United States tax" and "German tax" respectively.

In the case of the United States, as indicated in subparagraph 1(a), the covered taxes are the Federal income taxes imposed by the Code, together with the excise tax imposed on insurance premiums paid to foreign insurers (Code section 4371). With respect to the tax on insurance premiums, the Convention applies only to the extent that the risks covered by such premiums are not reinsured, directly or indirectly, with a person not entitled, under this or any other Convention, to exemption from the tax. The Article specifies that the Convention does not apply to the accumulated earnings tax (Code section 531), the personal holding company tax (Code section 541) or the social security taxes (Code sections 1401, 3101 and 3111). U.S. and German social security taxes are dealt within the bilateral Social Security Totalization Agreement, which entered into force on December 1, 1979, and was amended by a supplementary agreement signed on October 2, 1986. Except with respect to Article 24 (Nondiscrimination), state and local taxes in the United States are not covered by the Convention. Article 24 prohibits discriminatory taxation with respect to all taxes, whether or not they are covered taxes under Article 2, and whether they are imposed by the Contracting States,

their political subdivisions or local authorities.

Providing Convention coverage for the U.S. insurance excise tax effectively exempts German companies which insure U.S. risks from the tax, subject to the anti-conduit rule for reinsurance, described above. Under the Code, the tax is applicable to a German company only if it earns premiums which are not attributable to a permanent establishment in the United States. Under Article 7 (Business Profits), the United States does not subject the business profits of a German enterprise to tax (i.e., a covered tax) if the income of the enterprise is not attributable to a permanent establishment which the enterprise has in the United States. In contrast with this Convention, the 1954 Convention did not cover the insurance excise tax, thus allowing it to be imposed on premiums paid to German insurers which were not attributable to a permanent establishment of the German insurer in the United States. The 1954 Convention also did not exclude the accumulated earnings tax, personal holding company tax and social security taxes. The 1954 Convention had the same broad coverage for purposes of the nondiscrimination provisions as this Convention.

Subparagraph 1(b) specifics the existing German taxes which are covered by the Convention. They are the income tax (Einkommensteuer), the corporation tax (Koerperschaftsteuer), the trade tax (Gewerbesteuer) and the capital tax (Vermoegensteuer). These are the same as the German taxes covered by the 1954 Convention.

Under paragraph 2, the Convention will apply to any taxes which 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 August 29, 1989 (the date of signature of the Convention). The paragraph also provides that the U.S. and German competent authorities will notify each other of significant changes in their taxation laws. This refers to changes which are of significance to the operation of the Convention.

ARTICLE 3
General Definitions

Paragraph 1 defines a number of basic terms used in the Convention. Some terms are not defined in the Convention. These are dealt within paragraph 2. Certain others are defined in other articles of the Convention. For example, the term "resident of a Contracting State" is defined in Article 4 (Residence). 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, which deal with the taxation of those classes of income.

The terms "a Contracting State" and "the other Contracting State" are defined in subparagraph 1(a) to mean the United States or Germany, depending on the context in which the term is used.

The terms "United States" and "Federal Republic of Germany" are defined, for use in a geographical sense, in subparagraphs 1(b) and (c), respectively. The term "United States" is defined to mean the United States of America. The term does not include Puerto Rico, the Virgin

Islands, Guam or any other U.S. possession or territory. Although the Convention does not explicitly include the U.S. continental shelf within the definition of the United States, by virtue of section 638 of the Code the continental shelf is considered to be part of the United States for purposes of the Convention. The term "Federal Republic of Germany" means the area in which German tax law is in force. This includes the German continental shelf (with respect to the exploration or exploitation of natural resources), and, as provided in Article 31 (Berlin Clause), Land Berlin.

Subparagraph 1(d) defines the term "person" to include an individual or company. Because the term includes, but is not limited to, these two categories of person, this definition should not be interpreted as being substantively different from the definition of "person" in subparagraph l(a) of Article 3 of the U.S. Model, which also includes any other body of persons" within the definition.

The term "company" is defined in subparagraph l(e) as a body corporate or an entity treated as a body corporate for tax purposes. Since the term "body corporate" is not defined in the Convention, in accordance with paragraph 2 of this Article, it has the meaning which it has under the law of the Contracting State whose tax is being applied. Thus, for U.S. tax purposes, the principles of Code section 7701 will be applied to determine whether an entity is a body corporate. It is the understanding of the negotiators that generally a GmbH (Gesellschaft mit beschraenkter Haftung) will meet the requirements of section 7701, and be treated as a body corporate for U.S. tax purposes.

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.

Subparagraph 1(g) defines the term "international traffic". The term means any transport by a ship or aircraft except when the vessel is operating solely between places within a Contracting State. The exclusion from international traffic of transport solely between places within a Contracting State means, for example, that a carriage of goods or passengers between New York and Chicago by either a U.S. or a German carrier would not be treated as international traffic. 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. If the carrier is a German resident (if that were possible under U.S. law) the United States would not be required to exempt the income under Article 8. The income would, however, be treated as business profits under Article 7 (Business Profits), and would, therefore, be taxable in the United States only if attributable to a U.S. permanent establishment, and then only on a net basis. The gross basis U.S. tax would never apply under the circumstances described. If, however, goods or passengers are carried by a German carrier from Hamburg to New York, some of the goods or passengers are carried only to New York, and the rest are taken to Chicago, the entire transport would be international traffic.

The term "national", as it relates to both the United States and Germany, is defined in sub-subparagraphs 1(h)(aa) and (bb), respectively. A national of the United States is

(1) a U.S. citizen, and

(2) any legal person, partnership or association deriving its status, as such, from the law in force in the United States.

A national of Germany is defined, correspondingly, as

(1) a German within the meaning of paragraph 1 of Article 116 of the Basic Law of the Federal Republic of Germany, and

(2) any legal person, partnership or association deriving its status as such from the law in force in Germany.

These definitions are comparable to that found in the OECD Model, except that in that Model the definition is in Article 24 (Nondiscrimination). Since the term has application in other articles as well (e.g., Article 19 (Government Service; Social Security)), in this Convention it has been placed among the General Definitions. A U.S. national is defined in the U.S. Model as a citizen of the United States, and does not include juridical persons. The addition of juridical persons to the definition may have significance in relation to paragraph 1 of Article 24 (Nondiscrimination), which provides that nationals of one Contracting State not be subject in the other to any taxes or connected requirements that are other or more burdensome than those applicable to nationals of that other State who are in the same circumstances.

Sub-subparagraphs 1(i)(aa) and (bb) define the term "competent authority" for the United States and Germany 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 has, in turn, redelegated 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. In Germany, the competent authority is the Minister of Finance or his delegate. The competent authority functions in Germany are carried out by the Office for International Tax Relations with Industrial Countries in the Ministry of Finance.

Paragraph 2 provides that, in the application of the Convention, any term used but not defined in the Convention, unless the context requires otherwise, will have the meaning which it has under the law of the Contracting State whose tax is being applied. If, however, 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 which creates problems in the application of the Convention, the competent authorities may, pursuant to the provisions of paragraph 3(d) of Article 25 (Mutual Agreement Procedure), establish a common meaning in order to prevent double taxation or 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.

ARTICLE 4
Residence

This Article sets forth rules for determining whether a person is a resident of a Contracting State for purposes of the Convention. Determination of residence is important

because, as noted in the explanation to Article 1 (General Scope), 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 1954 Convention contains 110 comprehensive definition of residence. Article II of that Convention does provide that residence in Germany includes a customary place of abode in Germany.

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. A person who, under those laws, is a resident of one Contracting State and not of the other need look no further. That person is a resident for purposes of the Convention 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 assign one State of residence to such a person for purposes of the Convention through the use of tie-breaker rules.

Paragraph 1 defines a "resident of a Contracting State". In general, this definition incorporates the definitions of residence in U.S. and German law, 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 domicile, place of management, place of incorporation or any other similar criterion. Except as provided in Paragraph 2 of the Protocol, residents of the United States include aliens who are considered U.S. residents under Code section 7701(b). Unlike the U.S. Model, "citizenship" is not included among the criteria of residence. Thus, a U.S. citizen must have some tie to the United States in addition to citizenship to be treated as a U.S. resident for purposes of the Convention. (See discussion, below, of Paragraph 2 of the Protocol for the application of these rules to nonresident U.S. citizens and aliens lawfully admitted for permanent residence (i.e., "green card" holders).)

If, under subparagraph 1(a), a person is liable to tax in a Contracting State only in respect of income from sources within that State, or, in the case of Germany, only in respect of capital situated in Germany, the person will not be treated as a resident of that Contracting State for purposes of the Convention. Thus, for example, a German consular official 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. income, would not be considered a resident of the United States for purposes of the Convention. Similarly, a German enterprise with a permanent establishment in the United States is not, by virtue of that permanent establishment, a resident of the United States. The enterprise is subject to U.S. tax only with respect to its income which is attributable to the U.S. permanent establishment, not with respect to its worldwide income, as is a U.S. resident.

Under subparagraph 1(b), a partnership, estate or trust will be treated as a resident of a Contracting State for purposes of the Convention to the extent that the income derived by such person is subject to tax in that State as the income of a resident, either in the hands of the person deriving the income or in the hands of its partners or beneficiaries. Under U.S. law, a partnership is never, and an estate or trust is often not, a taxable entity. Thus, for U.S. tax purposes, the question of whether income received by a partnership is received by a resident will be determined by the residence of its partners (looking through any partnerships which are themselves partners) rather than by the residence of the partnership itself. Similarly, the

treatment under the Convention of income received by a trust or estate will be determined by the residence for taxation purposes of the person subject to tax on such income, which may be the grantor, the beneficiaries or the estate or trust itself, depending on the particular circumstances. This rule regarding the residence of partnerships, estates or trusts is applied to determine the extent to which that person is entitled to treaty benefits with respect to income which it receives from the other Contracting State.

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 2 to determine a single State of residence for that individual. The first test is 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 his Contracting State of citizenship. If he is a citizen of both States or of neither, the matter will be considered by the competent authorities, who will attempt by mutual agreement to assign a single State of residence.

Paragraph 2 of the Protocol elaborates on the rules to be used for determining whether a U.S. citizen or a green card holder is to be treated as a U.S. resident for purposes of the Convention. If such a person is a resident both of the United States and Germany, whether or not he is to be treated as a resident of the United States for purposes of the Convention is determined by the tie-breaker rules of paragraph 2 of the Article. If, however, he is resident in the United States and not Germany but has ties to a third State, in the absence of Protocol Paragraph 2 he would always be a resident of the United States, no matter how tenuous his relationship with the United States relative to that with the third State. Paragraph 2 of the Protocol provides that a U.S. citizen or green card holder 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, permanent home or habitual abode in the United States. Thus, for example, an individual resident of Mexico who is a U.S. citizen by birth, or who is a Mexican citizen and holds a U.S. green card, but who, in either case, has never lived in the United States, would not be entitled to German benefits under the treaty. On the other hand, a U.S. citizen employed by a U.S. corporation who is transferred to Mexico for two years but who maintains a permanent home or habitual abode in the United States would be entitled to treaty benefits.

Paragraph 3 seeks to settle dual-residence issues for persons other than individuals. A corporation is treated as resident in the United States if it is created or organized under the laws of the United States or a political subdivision. Under German law a corporation is treated as a resident of Germany if it is either incorporated or managed and controlled there. Dual residence, therefore, can arise if a U.S. corporation is managed in Germany. Since neither party was prepared to give up its test of corporate residence under a tie-breaker, the paragraph provides that if a corporation or other person, other than an individual, is resident in both the United States and Germany under paragraph 1, the competent authorities shall seek to determine a single State of residence for that person for purposes of the Convention. If, however, they are unable to reach

agreement, that person shall not be considered to be a resident of either the United States or Germany 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 Germany, the U.S. paying agent would withhold on that dividend at the appropriate treaty rate, since reduced withholding is a benefit enjoyed by the resident of Germany, not by the dual resident. The dual resident corporation which is the payor of the dividend would, for this purpose, be treated as a resident of the United States under the Convention.

ARTICLE 5
Permanent Establishment

This Article defines the term "permanent establishment". This definition 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 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 which the recipient has in the source State.

This Article follows closely both the U.S. and OECD Model provisions. It does not differ in substance from the definition of a permanent establishment in the 1954 Convention.

Paragraph 1 provides the basic definition of the term "permanent establishment". 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.

Paragraph 2 contains a list of fixed places of business which will constitute a permanent establishment. The list is illustrative and nonexclusive. According to paragraph 2, the term permanent establishment includes a place of management, a branch, an office, a factory, a workshop, and a mine, quarry or other place of extraction of natural resources.

Paragraph 3 provides rules to determine when a building site or a construction, assembly or installation project constitutes a permanent establishment. Only if the site, project, etc., lasts for more than twelve months does it constitute a permanent establishment. The twelve-month test applies separately to each individual site or project. The twelve-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 which are interdependent both commercially and geographically are to be treated as a single project for purposes of applying the twelve-month threshold test. For example, the construction of a housing development 'would be considered as a single project even if each house is constructed for a different purchaser. If the twelve-month

threshold is exceeded, the site or project constitutes a permanent establishment from its first day. This interpretation of the Article is based on the Commentaries to paragraph 3 of Article 5 of the OECD Model, which contains language almost identical to that in the Convention. This interpretation, therefore, constitutes the generally accepted international interpretation of the language in paragraph 3 of Article 5 of the Convention. It is understood that drilling rigs, both onshore and offshore, are covered by this construction site rule, and must, therefore, be present in a Contracting State for 12 months to constitute a permanent establishment.

Paragraph 4 contains exceptions to the general rule of paragraph 1 that a fixed place of business through which a business is carried on constitutes a permanent establishment. The paragraph lists a number of activities which may be carried on through a fixed place of business, but which, nevertheless, will not give rise to a permanent establishment. The use of facilities solely to store, display or deliver merchandise belonging to an enterprise will 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 will not give rise to a permanent establishment of the first-mentioned enterprise. The maintenance of a fixed place of business solely for activities that have a preparatory or auxiliary character for the enterprise, such as advertising, the supply of information or scientific activities, will not constitute a permanent establishment of the enterprise. A combination of these activities will not give rise to a permanent establishment so long as the combination results in an overall activity that is of a preparatory or auxiliary character. This combination rule differs from that in the U.S. Model. In the Model, any combination of otherwise excepted activities is not deemed to give rise to a permanent establishment, without the qualification in the Convention that the combination, as distinct from each constituent activity, be preparatory or auxiliary. It is assumed that, as a general rule, if activities which are, themselves, preparatory or auxiliary arc combined, the combination will also be of a character which is preparatory or auxiliary. If, however, this is not the case, a permanent establishment may result from a combination of activities.

Paragraphs 5 and 6 specify when the use of an agent will constitute a permanent establishment. Under paragraph 5, a dependent agent of an enterprise will be 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, his 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 will not be a permanent establishment of the enterprise.

Under paragraph 6, an enterprise will not be 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.

Paragraph 7 clarifies that a company which is a resident of a Contracting State will not be 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 of whether or not a

permanent establishment exists will be made solely on the basis of the factors described in paragraphs 1 through 6 of the Article. Whether or not 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.

Paragraph 3 of the Protocol refers to Article 5, in relation to permanent establishments, and to Article 14 (Independent Personal Services) in relation to fixed bases. The paragraph provides that a resident of a Contracting State that performs in artistic performances (such as, for example, circuses, ice revues and similar shows) in the other Contracting State and is not subject to tax in that other State under the provisions of Article 17 (Artistes and Athletes), will not be deemed to have a permanent establishment or a fixed base in that other State if the person's presence there does not exceed 183 days in the calendar year.

ARTICLE 6
Income from Immovable (Real) Property

Paragraph 1 provides 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. This Article does not grant an exclusive taxing right to the situs State, but merely grants it the primary right to tax. The Article does not impose any limitation in terms of rate or form of tax on the situs State. As clarified in paragraph 3, the income referred to in paragraph 1 means income from any use of real property, including, but not limited to, income from direct use by the owner and rental income from the letting of real property.

Paragraph 2 defines the term "immovable property", which, as is made clear by the use of the term "real" in the title to the Article and in paragraph 1, is to be understood, for U.S. purposes, to have the same meaning as the term "real property" in the United States. The term is to have the same meaning that it has under the law of the situs country. In addition, the paragraph specifies certain classes of property which, regardless of internal law definitions, are to be included within the meaning of the term for purposes of the Convention.

Paragraph 4 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 of a resident of the other Contracting State in the absence of a permanent establishment or fixed base in the situs State, notwithstanding the requirements of Articles 7 (Business Profits) and 14 (Independent Personal Services) that in order to be taxable, income must be attributable to a permanent establishment or fixed base, respectively.

The provision in the U.S. Model for a binding election by the taxpayer to be taxed on real property income on a net basis was not included in the Convention. Both Contracting States provide for net basis taxation of such income under internal law, and, therefore, an election provision is not needed.

ARTICLE 7
Business Profits

This Article provides the rules for the taxation by a Contracting State of the business profits of an enterprise of the other Contracting State. The general rule is found in paragraph 1, 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. Where that condition is met, the State in which the permanent establishment exists may tax the income of the enterprise, but only so much of the income as is attributable to the permanent establishment. This differs from the comparable rule in the 1954 Convention, which contained a limited force of attraction rule. That rule permitted the State in which the permanent establishment is located to tax income of the enterprise even if not attributable to the permanent establishment, if the income is derived from sources in that State from the sale of goods or merchandise of the same kind as that sold through the permanent establishment or from other transactions of the same kind as those effected through the permanent establishment.

Paragraph 2 provides rules for the proper attribution of business profits to a permanent establishment. It provides that the Contracting States will attribute to a permanent establishment the profits which it would have earned had it been an independent entity, engaged in the same or similar activities under the same or similar circumstances. The computation of the 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 income. The profits attributable to a permanent establishment may be from sources within or without a Contracting State. Thus, certain items of foreign source income described in section 864(c)(4)(B) of the Code may be attributed to a U.S. permanent establishment of a German enterprise and subject to tax in the United States. The concept of "attributable to" in the Convention is narrower than the concept of "effectively connected" in section 864(c) of the Code. The limited "force of attraction" rule in Code section 864(c)(3), therefore, is not applicable under the Convention.

Paragraph 4 of the Protocol elaborates on paragraphs 1 and 2 of Article 7, and on paragraph 3 of Article 13 (Gains). This Protocol paragraph incorporates the rule of Code section 864(c)(6) into the Convention. Like the Code section on which it is based, Paragraph 4 of the Protocol provides that any income or gain attributable to a permanent establishment (or, in the context of Article 13, a fixed base as well) during its existence is taxable in the Contracting State where the permanent establishment (or fixed base) is situated even if the payments are deferred until after the permanent establishment (or fixed base) no longer exists. The Protocol provision goes beyond the Code section on which it is based by clarifying that expenses attributable to the permanent establishment (or fixed base) during its existence may be deducted from the deferred income at such time as that income is subject to tax.

Paragraph 5 of the Protocol incorporates into Articles 7 and 13 of the Convention a rule similar to that of Code section 864(c)(7). Under the Code rule, if an asset which had been part of the business property of a U.S. trade or business (or, in a treaty context, of a permanent

establishment or fixed base in the United States) is alienated within ten years of its removal from the U.S. trade or business (or permanent establishment/fixed base), the gain realized on such alienation is subject to U.S. tax. Under Paragraph 5 of the Protocol, a right of the Contracting State in which the permanent establishment (or fixed base) exists or existed to tax such gains is confirmed, but the taxable gain is limited to that portion which accrued during the time that the asset formed part of the business property of the permanent establishment (or fixed base). The tax may be imposed under the Convention if the alienation occurs within ten years of the date on which the property ceased to be part of the business property of the permanent establishment (or fixed base). If, however, the laws of either Contracting State provide for a look-back period shorter than ten years, that shorter period will al)ply with respect to the tax of both Contracting States under the Convention. This rule in Paragraph 5 of the Protocol combines certain features of the laws of both the United States and Germany. It limits German law by imposing the ten year limit of U.S. law on either Contracting State's right to tax such gains, and it restricts U.S. law by limiting the taxable gain, as under German law, to the gain which accrued while the property formed part of the business property of the permanent establishment (or fixed base).

Paragraph 3 provides that in determining the business profits of a permanent establishment, deductions shall be allowed for expenses incurred for the purposes of the permanent establishment. Deductions are to be allowed regardless of where the expenses are incurred. The paragraph specifies that among the expenses referred to which are incurred for the purposes of the permanent establishment are expenses for research and development, interest and other similar expenses. Also included is a reasonable amount of executive and general administrative expenses. The language of this paragraph differs in minor respect from that in the U.S. Model. The U.S. Model refers to a "reasonable allocation" of the enumerated expenses; this paragraph in the Convention omits this reference. During the negotiations, the German delegation observed that the U.S. Model language seems to require both Contracting States to apply the sorts of expense allocations that are found in U.S. law, as, for example, in regulation sections 1.861-8 and 1.882-5. Leaving out the reference to "reasonable allocation" is understood to make clear that each State may use its own rules, whether tracing or allocation rules, for attributing expenses to a permanent establishment.

Paragraph 6 of the Protocol refers to paragraph 3 of Article 7 of the Convention. The Protocol Paragraph provides that the competent authorities may by mutual agreement determine common procedures for allocating expenses to a permanent establishment which may differ from the procedures used under the laws of the Contracting States. The language of this Paragraph of the Protocol reinforces the point made in the preceding paragraph of this explanation, that (in the absence of a mutual agreement to the contrary) the Contracting States may under the Convention use their own internal law rules for determining the expenses which are to be allowed as deductions in calculating the income of a permanent establishment.

Paragraph 4 provides that no business profits will be attributed to a permanent establishment merely because it purchases goods or merchandise for the enterprise of which it is a permanent establishment. This rule refers to a permanent establishment which performs more than one function for the enterprise, including purchasing. For example, the permanent establishment may purchase raw materials for the enterprise's manufacturing operation and sell the manufactured output, while business profits may be attributable to the permanent

establishment with respect to its sales activities, no profits are attributable with respect to its purchasing activities. If the sole activity were the purchasing of goods or merchandise for the enterprise the issue of the attribution of income would not arise, because, under subparagraph 4(d) of Article 5 (Permanent Establishment), there would be no permanent establishment.

Paragraph 5 states that the business profits attributed to a permanent establishment are only those derived from its assets or activities. This clarifies the fact, as noted in connection with paragraph 2 of the Article, that the Code concept of effective connection, with its limited "force of attraction", is not incorporated into the Convention.

Paragraph 6 explains the relationship between the provisions of Article 7 and other provisions of the Convention. Under paragraph 6, where business profits include items of income that are dealt with separately under other articles of the Convention, the provisions of those articles will, except where they specifically provide to the contrary, take precedence over the provisions of Article 7. Thus, for example, the taxation of interest will be determined by the rules of Article 11 (Interest), and not by Article 7, except where, as provided in paragraph 3 of Article 11, the interest is attributable to a permanent establishment, in which case the provisions of Article 7 apply.

Paragraph 7 specifies that the term "business profits" as used in the Convention includes two classes of income which, in some countries, are subject to gross basis taxation at source and in the OECD Model Convention are treated as royalties under Article 12. These are income from the rental of tangible personal property and income from the rental or licensing of motion picture films or works on film, tape or other means of reproduction for use in radio or television broadcasting. The inclusion of these classes of income in business profits means that such income earned by a resident of a Contracting State can be taxed by the other Contracting State only if the income is attributable to a permanent establishment maintained by the resident in that other State, and, if the income is taxable, it can be taxed only on a net basis. The comparable provision in the U.S. Model also provides a general definition which says that the term "business profits" means income derived from any trade or business. The absence of this definition from the Convention does not indicate any difference in the meaning to be attributed to the term.

This Article is subject to the saving clause of subparagraph (a) of Paragraph 1 of the Protocol. Thus, if, for example, a citizen of the United States who is a resident of Germany derives business profits from the United States which 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 as part of the worldwide income of the citizen, notwithstanding the provisions of this Article under which such income derived by a resident of Germany is exempt from U.S. tax.

ARTICLE 8
Shipping and Air Transport

This Article provides the rules which govern 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). Paragraph 1 provides that profits derived by an enterprise of a Contracting State from the operation in international traffic of ships or aircraft shall be taxable only in that Contracting State. By virtue of paragraph 6 of Article 7 (Business Profits), profits of an enterprise of a Contracting State that are exempt in the other Contracting State under this paragraph remain exempt even if the enterprise has a permanent establishment in that other Contracting State.

Income of an enterprise of a Contracting State from the rental of ships or aircraft on a full basis (i.e., with crew) is considered to be income from the operation of ships and aircraft and is, therefore, exempt from tax in the other Contracting State under paragraph 1. Unlike the U.S. Model, income from bareboat rentals of ships or aircraft is not included within the definition of profits from the operation of ships or aircraft in international traffic in the Convention. Such income is treated, consistent with paragraph 7 of Article 7 (Business Profits), as business profits. Only the rental income that is attributable to a permanent establishment which the lessor, a resident of one Contracting State, has in the other Contracting State can be taxed in that other State. It is understood that if, for example, a bank is a resident of one Contracting State and has a permanent establishment in the other Contracting State, and that bank leases an aircraft to an airline in the other Contracting State, if the permanent establishment was not involved in negotiating or concluding the lease agreement, the rental income will not be attributable to the permanent establishment and, therefore, will not be subject to tax by that other State.

Paragraph 2 provides that the profits of an enterprise of a Contracting State from the use or rental of containers (including equipment for their transport) which are used for the transport of goods in international traffic will be exempt from tax in the other Contracting State. This result obtains regardless of whether the recipient of the income is engaged in the operation of ships or aircraft in international traffic, and regardless of whether the enterprise has a permanent establishment in the other Contracting State. The comparable provision in the U.S. Model (Article 8, paragraph 3) speaks of profits from the "use, maintenance, or rental of containers". The absence of the word "maintenance" in the Convention is not intended to lead to a different result. The word was deleted at the request of the German delegation to avoid giving the mistaken impression that income derived from a business of providing maintenance services for containers owned and used by other enterprises would be exempt from tax. It is understood, however, that if a shipping company or container leasing company which is a resident of one Contracting State operates a facility for maintaining its own containers in the other Contracting State, the company will be exempt from tax in that other Contracting State even if the facility constitutes a permanent establishment. The shipping and air transport provisions of the 1954 Convention do not deal with income from the use or rental of containers. Such income, therefore, is treated under that Convention as royalty income or business profits, depending upon the circumstances.

Paragraph 3 clarifies that the provisions of the preceding paragraphs apply equally to profits derived by an enterprise of a Contracting State from participation in a pool, joint business or international operating agency. As with any benefit of the Convention, the enterprise claiming the benefit must be entitled to the benefit under the provisions of Article 28 (Limitation on Benefits).

The taxation of gains from the alienation of ships, aircraft or containers is not dealt within this Article, but in paragraph 4 of Article 13 (Gains).

This Article is subject to the saving clause of subparagraph (a) of Paragraph 1 of the Protocol. The United States, therefore, may, subject to the special foreign tax credit rules of paragraph 3 of Article 23 (Relief from Double Taxation), tax the shipping or air transport profits of a resident of Germany if that German resident is a citizen of the United States.

ARTICLE 9
Associated Enterprises

This Article incorporates into the Convention the general principles of section 482 of the Code. It provides that when related persons engage in transactions that are not at arm's length, the Contracting States may make appropriate adjustments to the taxable income and tax liability of such related persons to reflect what the income or tax of these persons with respect to such transactions would have been had there been an arm’s length relationship between the persons.

Paragraph 1 deals with the circumstance where an enterprise of a Contracting State is related to an enterprise of the other Contracting State, and those related persons make arrangements or impose conditions between themselves in their commercial or financial relations which are different from those that would be made between independent persons. Paragraph 1 provides that, under those circumstances, the Contracting States may adjust the income (or loss) of the enterprise to reflect the income which would have been taken into account in the absence of such a relationship. The paragraph specifies what the term "related persons" means in this context. An enterprise of one Contracting State is related to an enterprise of the other Contracting State if either participates directly or indirectly in the management, control, or capital of the other. The two enterprises are also related if any third person or persons participate directly or indirectly in the management, control, or capital of both. The term "control" includes any kind of control, whether or not legally enforceable and however exercised or exercisable.

Paragraph 2 provides that where 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 corresponding adjustment to the tax liability of the related person in that other Contracting State. The Contracting State making such an adjustment will take the other provisions of the Convention, where relevant, into account. For example, if the effect of a correlative adjustment is to treat a German corporation as having made a distribution of profits to its U.S. parent corporation, the provisions of Article 10 (Dividends) will apply, and Germany may impose a 5 percent withholding tax on the dividend. The competent authorities are authorized, if necessary, to consult 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, pursuant to paragraph 2 of Article 25 (Mutual Agreement Procedure), notwithstanding any time limits or

other procedural limitations in the law of the Contracting State making the adjustment. The saving clause of subparagraph (a) of Paragraph 1 of the Protocol does not apply to paragraph 2 of Article 9 (see the exceptions to the saving clause in sub-subparagraph (b)(aa) of Paragraph 1 of the Protocol). Thus, even if the statute of limitations has run, or there is a closing agreement between the Internal Revenue Service and the taxpayer, 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, under subparagraph (c) of Paragraph 1 of the Protocol, the Convention cannot restrict any statutory benefit.

Paragraph 7 of the Protocol relates to Article 9 of the Convention. It has the same purpose as paragraph 3 of Article 9 of the U.S. Model. That paragraph of the U.S. Model is not in the Convention. The paragraph preserves the rights of the Contracting States to apply internal law provisions relating to adjustments between related parties. 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, so 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. Paragraph 7 of the Protocol also makes clear that Article 9 does not limit the rights of the Contracting States to allocate income between related persons in cases where the relationship is different from that described in paragraph 1 of the Article. This rule would apply, for example, if a commercial or contractual relationship results in the ability of one party to exercise a controlling influence over another. Any adjustments made pursuant to this provision of the Protocol must accord with the general principles of paragraph 1 of Article 9.

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 in such a way that it does not represent a departure in U.S. practice or policy from the arm’s length standard. It merely suggests alternative approaches, beyond those spelled out in current regulations, for achieving appropriate transfer prices. It is anticipated, therefore, that the application of this standard by the Internal Revenue Service will be in accordance with the general principles of paragraph 1 of Article 9 of the Convention, and of Paragraph 7 of the Protocol.

ARTICLE 10
Dividends

Article 10 provides rules for source, and in some cases residence, country taxation of dividends and similar amounts paid by a company resident in one Contracting State to a resident of the other Contracting State. Article 10 also provides rules for the imposition of a tax on branch profits. Generally, the article limits the source country's right to tax dividends and amounts treated as dividends or dividend equivalents.

Paragraph 1 preserves the residence country's general right to tax dividends arising in the source country by permitting a Contracting State to tax its residents on dividends paid by a company that is a resident of the other Contracting State. Under the provisions of subparagraph

2(a) of Article 23, Germany may not exercise this right with respect to certain direct investment dividends.

Paragraph 2 grants the source country the right to tax dividends paid by a company that is a resident of that country. If the beneficial owner of the dividend is a resident of the other Contracting State, the source country tax is limited to 5 percent of the gross amount of the dividend if the beneficial owner is a company that holds directly at least 10 percent of the voting shares of the company paying the dividend and 15 percent of the gross amount of the dividend in all other cases. Indirect ownership of voting shares (e.g., through tiers of corporations) and direct ownership of nonvoting shares are not included for purposes of determining eligibility for the 5 percent direct dividend rate. Paragraph 10 of the Protocol provides that the source state shall treat the recipient of a dividend as the beneficial owner of such dividend for purposes of Article 10 if the recipient is the person to which the dividend income is attributable for tax purposes under the laws of the source state.

Under the 1954 Convention, dividends are generally taxable by the source country at a maximum rate of 15 percent. Paragraph 4 of Article 32 (Entry into Force) provides a special phase-in rule for the 5 percent direct dividend rate, which will generally not be available until 1992. Between 1990 and 1992, direct dividends are generally subject to a 10 percent source country tax under the phase-in rule.

The second and third sentences of paragraph 2 relax the limitations on source country taxation for dividends paid by U.S. Regulated Investment Companies and Real Estate Investment Trusts and by German investment trusts. Dividends paid by Regulated Investment Companies and German investment trusts are denied the 5 percent direct dividend rate and subjected to the 15 percent portfolio dividend rate regardless of the percentage of voting shares held directly by the recipient of the dividend. Generally, the reduction of the dividend rate to 5 percent is intended to relieve multiple levels of corporate taxation in cases where the recipient of the dividend holds a substantial interest in the payor. Because Regulated Investment Companies, Real Estate Investment Trusts, and German investment trusts do not themselves generally pay corporate tax with respect to amounts distributed, the rate reduction from 15 to 5 percent cannot be justified by the "relief from multiple levels of corporate taxation" rationale. Further, although amounts received by a Regulated Investment Company may have been subject to 11.5. corporate tax (e.g., dividends paid by a publicly traded U.S. company to a Regulated Investment Company), it is unlikely that a 10 percent shareholding in a Regulated Investment Company by a German resident will correspond to a 10 percent shareholding in the entity that has paid U.S. corporate tax (e.g., the publicly traded U.S. company). Thus, in the case of dividends received by a Regulated Investment Company and paid out to its shareholders the requirement of a substantial shareholding in the entity paying the corporate tax is generally lacking.

The third sentence of paragraph 2 further limits the availability of the 15 percent portfolio dividend rate in the case of Real Estate Investment Trusts. The 15 percent rate is available only to individual residents of the Federal Republic of Germany holding a less than 10 percent interest in the Real Estate Investment Trust. The exclusion of corporate shareholders and 10 percent or greater individual shareholders from the 15 percent portfolio rate is intended to prevent indirect investment in U.S. real property through a Real Estate Investment Trust from being treated more

favorably than investment directly in such real property. Dividends paid by a Real Estate Investment Trust (other than amounts subject to tax as effectively connected income under section 897(h) of the Code) that are not entitled to the 15 percent portfolio rate are subject to the U.S. statutory rate of 30 percent.

Paragraph 2 does not affect the taxation of the profits out of which the dividends are paid.

Paragraph 3 provides that as long as natural persons resident in the Federal Republic of Germany are entitled under German law to a tax credit in respect of dividends paid by a company that is a resident of Germany (i.e., as long as the German imputation system remains in force), the U.S. beneficial owner of portfolio dividends subject to the 15 percent rate of subparagraph 2(b) shall be entitled to a further relief of German tax equal to 5 percent of the gross amount of the dividend. For United States income tax purposes (including for purposes of credit for foreign taxes paid), the benefit resulting from the further 5 percent relief of German tax shall be treated as a dividend paid to the U.S. beneficial owner. Paragraph 8 of the Protocol clarifies the U.S. tax treatment of the 5 percent reduction in German tax. For U.S. tax purposes, the U.S. shareholder is treated as if it had received as a dividend a refund of German corporate tax equal to 5.88 percent of the dividend actually paid, determined before the German withholding tax on such dividend. The sum of this refund and such actual dividend are deemed to have been subject to the 15 percent German tax on portfolio dividends prescribed in subparagraph 2(b) of Article 10

For example, if a German company pays an actual dividend of $I00 to a resident of the United States, such dividend will, under subparagraph 2(b), be subject to German tax of $15. However, the "further relief" described in subparagraph 3(a) of Article 10 effectively reduces the German withholding tax to $10. Pursuant to subparagraph 3(b) of Article 10, for U.S. tax purposes the U.S. resident is treated as if it received a dividend of $105.88 consisting of the $l00 actual dividend and a refund of German corporate tax of $5.88. The notional $105.88 dividend is deemed to have been subject to a German withholding tax of $15.88 (15 percent of $105.88 equals $15.88). The U.S. resident will include in gross income $105.88 and will be entitled to a foreign tax credit of $15.88, subject to the generally applicable limitations of U.S. law.

Paragraph 4 defines the term dividends as used in Article 10 to mean income from shares, "jouissance" rights, mining shares, founders' shares, or other rights (not being debt-claims) participating in profits, as well as other income derived from other rights that is subjected to the same taxation treatment as income from shares by the laws of the Contracting State of which the company making the distribution is a resident. In the case of the Federal Republic of Germany dividends also include income from sleeping partnerships and certain participating loans, as well as distributions on a certificate of investment trust. Under the 1954 Convention, income from participating loans was generally treated as interest.

Paragraph 5 provides that, notwithstanding the limitations on source country taxation contained in paragraph 2 of Article 10 and paragraph 1 of Article 11, income from arrangements, including debt obligations, carrying the right to participate in profits that is deductible in determining the profits of the payor may be taxed in the source state according to the laws of such state. In the case of the Federal Republic of Germany, as long as income from sleeping

partnerships, participating loans, and jouissance shares remains deductible in determining the profits of the payor, such income is excepted from the Article 10 and Article 11 limitations on the source country's right to impose its domestic law. In the case of the United States, paragraph 5 permits the United States to impose its statutory regime on similar deductible distributions of profits. Thus, for example, interest paid with respect to a loan that gives the German lender a right to participate indirectly in the profits of the U.S. obligor through the receipt of contingent interest calculated by reference to the profitability of the U.S. obligor (or property held by the U.S. obligor) is subject to the U.S. statutory system of withholding on interest not attributable to a permanent establishment. The U.S. withholding tax, if any, on such interest is not affected by the Article 11 source country exemption. This exception from the source country limitation does not apply to interest paid with respect to debt convertible into an equity interest in the obligor, so long as the interest payments themselves are not contingent on the profitability of the obligor. If either Contracting State enacts domestic legislation that denies the deductibility of payments otherwise addressed in paragraph 5, then paragraph 5 by its terms no longer applies. In such a case, the limitations on source country taxation contained in Articles 10 and 11 would govern source country taxation.

Paragraph 6 excludes dividends paid with respect to holdings that form part of the business property of a permanent establishment or fixed base from the general source country limitations. 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.

Paragraph 7 bars one Contracting State from imposing any tax on dividends paid by a company resident in the other Contracting State except insofar as such dividends are otherwise subject to net basis taxation in the first-mentioned Contracting State because such dividends are paid to a resident of such first mentioned Contracting State or the holding in respect of which the dividends are paid forms part of the business property of a permanent establishment or fixed base situated in such first-mentioned State.

Paragraph 8 provides for the imposition of a branch profits tax by the State in which certain items of income arise. Paragraph 8 permits the State in which the branch operates to impose an additional tax (e.g., a branch profits tax such as that imposed by section 884(a) of the Code) on a company that is resident in the other Contracting State and that has a permanent establishment in the first mentioned State or that is subject to net basis taxation in such State under Article 6 or paragraph 1 of Article 13. In the case of the United States, such additional tax may be imposed only on the portion of the business profits of a company attributable to the permanent establishment and the portion of net income subject to tax under Article 6 or paragraph I of Article 13 that represent the dividend equivalent amount. For this purpose, "dividend equivalent amount" has the same meaning it has under United States law, as amended from time to time without changing the general principle thereof.

Thus, for example, the United States may impose its branch profits tax on business profits of a German company attributable to a permanent establishment in the United States. In addition, the United States may impose its branch profits tax on income of a German corporation subject to taxation on a net basis because the German corporation has elected under Code section 882(d)

to treat income from real property not otherwise taxed on a net basis as effectively connected income, or because the gain arises from the disposition of a United States Real Property Interest other than an interest in a United States corporation. The United States may not impose its branch tax on the business profits of a German corporation 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.

In the case of the Federal Republic of Germany, the additional tax permitted by paragraph 8 may be imposed only on that portion of income that is comparable to the amount that would be distributed as a dividend by a German corporation to its U.S. shareholder.

Paragraph 9 provides that the branch profits tax permitted by paragraph 8 shall not be imposed at a rate exceeding the direct dividend withholding rate of five percent. Subparagraph 5(a) of Article 32 (Entry Into Force) provides for the imposition of the branch tax for the first time for assessment periods or taxable years beginning on or after January 1, 1991. This means, also, that in computing the base of the U.S. tax, only post-effective date not-previously-taxed effectively connected income will be taken into account.

Paragraph 10 further limits the imposition of a branch profits tax by the Federal Republic of Germany. Such a tax may be imposed only if, under German law, a foreign corporation is subject to a rate of tax that does not exceed the rate of corporation tax applicable to the distributed profits of a German company by 5 percentage points or more. If the branch tax is permitted, the sum of the branch tax rate and the number of percentage points by which the German tax on a permanent establishment of a foreign corporation exceeds the German tax on distributed profits of a German corporation may not exceed 5 percentage points. Thus, as long as Germany taxes foreign branches at a rate of 46 percent and distributed profits of a German corporation at a rate of 36 percent, the imposition of a further German branch tax is proscribed.

Notwithstanding the foregoing limitations on source country taxation of dividends, the saving clause of subparagraph (a) of Paragraph 1 of the Protocol permits the United States to tax dividends received by its residents and citizens, subject to the special foreign tax credit rules of paragraph 3 of Article 23 (Relief from Double Taxation), as if the Convention had not come into effect.

ARTICLE 11
Interest

Article 11 provides rules for source and residence country taxation of interest.

Paragraph 1 grants to the residence state the exclusive right to tax interest derived and beneficially owned by its residents. Thus, the exemption at source for interest in the 1954 Convention is generally carried forward to this Convention. Paragraph 10 of the Protocol provides that the source state shall treat the recipient of interest income as the beneficial owner of such income if the recipient is the person to which the income is attributable for tax purposes under the laws of the source state.

Paragraph 2 defines the term "interest" as used in Article II to include, inter alia, income from debt-claims of every kind, whether or not secured by a mortgage, as well as income treated as income from money lent by the taxation law of the source state. Penalty charges for late payment arc excluded from the definition of interest. Income dealt within Article 10 is also excluded from the definition of interest. Thus, for example, income from a debt obligation carrying the right to participate in profits is not covered by Article 11, even if such income is treated as interest under the law of the source state. Rather, the respective rights of the source and residence states to tax such income are determined under Article 10.

Paragraph 3 provides an exception from the rule of Paragraph 1 that bars a source country tax on interest in cases where the beneficial owner of the interest carries on business through a permanent establishment in the source state or performs independent personal services from a fixed base situated in the source state and the debt-claim in respect of which the interest is paid forms part of the business property of such 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 source state will generally retain the right to impose tax on such interest income.

Paragraph 4 provides that in cases involving special relationships between persons, Article 11 applies only to interest payments 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 the Federal Republic of Germany, respectively, with due regard to the other provisions of the Convention. Thus, for example, if the excess amount would be treated as a distribution of profits, such amount could be taxed as a dividend rather than as interest, but the tax would be subject to the rate limitations of paragraph 2 of Article 10 (Dividends).

Paragraph 5 limits the right of one Contracting State to impose tax on interest payments made by a company deriving income from such State that is a resident of the other Contracting State. Such a tax may be imposed only on interest paid by a permanent establishment of such company located in the first-mentioned state, interest paid out of income subject to the branch profits tax permitted by paragraph 8(a)(bb) of Article 10 (Dividends) in the first-mentioned State, interest paid to a resident of the first-mentioned State, or interest paid with respect to a debt-claim that forms part of the business property of a permanent establishment or fixed base situated in the first-mentioned State. Thus, for example, if a German company derives income from the United States that is subject to the United States branch profits tax even though such German company has no permanent establishment in the United States (e.g., because such company makes an election to be taxed on a net basis under section 882(d) of the Code or such company disposes of a United States Real Property Interest), the United States retains the right to tax interest payments made by such company. Interest paid by a U.S. permanent establishment of a German company to a resident of Germany, however, is not subject to U.S. tax by virtue of paragraph 1 of Article 11.

Paragraph 11 of the Protocol provides that the excess of the amount of interest deductible by a German company over the interest actually paid by such permanent establishment shall be treated as interest derived and beneficially owned by a resident of Germany. Thus, the Article II

exemption from source country taxation will generally prevent the collection of the excess interest tax imposed by section 884(f) of the Code.

Notwithstanding the foregoing limitations on source country taxation of interest, the saving clause of subparagraph (a) of Paragraph 1 of the Protocol permits the United States to tax its residents and citizens, subject to the special foreign tax credit rules of paragraph 3 of Article 23 (Relief from Double Taxation), as if the Convention had not come into force.

ARTICLE 12
Royalties

Article 12 provides rules for source and residence country taxation of royalties.

Paragraph 1 grants to the residence state the exclusive right to tax royalties derived and beneficially owned by its residents. Thus, the exemption at source for royalties in the 1954 Convention is carried forward to the Convention. Paragraph 10 of the Protocol provides that the source state shall treat the recipient of royalties as the beneficial owner of such royalties for purposes of Article 12 if the recipient is the person to which the income is attributable for tax purposes under the laws of the source state.

Paragraph 2 generally follows the U.S. Model and defines the term "royalties as used in Article 12 to mean 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; 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. The term also includes gains derived from the alienation of any such right or property that are contingent on the productivity, use, or further alienation thereof. Payments received in connection with the use or right to use cinematographic films, or works on film, tape, or other means of reproduction in radio or television broadcasting are specifically excluded from the definition of royalties. Such payments are covered by the provisions of Article 7 (Business Profits). The reference to "other means of reproduction" makes clear that subsequent technological advances in the field of radio and television broadcasting will not affect the exclusion of payments relating to the use of such means of reproduction from the definition of royalties.

Paragraph 12 of the Protocol makes clear that when an artiste who is resident in one Contracting State records a performance in the other Contracting State, has a copyrightable interest in the recording as determined under the law of the other Contracting State, and receives consideration for the right to use the recording based on the sale or public playing of such recording, then the right of such other Contracting State to tax such consideration shall be governed by Article 12.

Paragraph 3 of Article 12 provides an exception from the rule of Paragraph 1 that bars a source country tax on royalties in cases where the beneficial owner of the royalties carries on business through a permanent establishment in the source state or performs independent personal

services from a fixed base situated in the source state and the right or property in respect of which the royalties are paid forms part of the business property of such 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 source state will generally retain the right to tax such royalties.

Paragraph 4 provides that in cases involving special relationships between the payor and beneficial owner of a royalty, Article 12 applies only to the extent of royalty payments that would have been made absent such special relationships (i.e., an arm's length royalty payment). Any excess amount of royalties paid remains taxable according to the laws of the United States and the Federal Republic of Germany, respectively, with due regard to the other provisions of the Convention. If, for example, the excess amount is treated as a distribution of profits under national law, such excess amount will be taxed as a dividend rather than as a royalty payment, but the tax imposed on the dividend payment will be subject to the rate limitations of paragraph 2 of Article 10 (Dividends).

Notwithstanding the foregoing limitations on source country taxation of royalties, subparagraph (a) of Paragraph 1 of the Protocol permits the United States to tax its citizens, subject to the special foreign tax credit rules of paragraph 3 of Article 23 (Relief from Double Taxation), and its residents as if the Convention had not come into effect.

ARTICLE 13
Gains

Article 13 provides rules for source and residence country taxation of gains from the alienation of property.

Paragraph 1 of Article 13 preserves the source country right to tax gains derived from the alienation of immovable property situated in the source (i.e., situs) State. Thus, paragraph 1 permits gains derived by a resident of one Contracting State from the alienation of immovable property referred to in Article 6 (Income from Immovable (Real) Property) and situated in the other Contracting State to be taxed by such other Contracting State.

For purposes of Article 13 only, paragraph 2 defines "immovable property situated in the other Contracting State" to include immovable property referred to in Article 6 (i.e., interests in the immovable property itself) and certain indirect interests in immovable property. Such indirect interests include shares or comparable interests in a company that is (or is treated as) a resident of the source state, the assets of which company consist or consisted wholly or principally of immovable property situated in the source state. The reference to companies "treated as" residents of the source state makes clear that interests in non-U.S. corporations that have elected under section 897(i) of the Code to be treated as U.S. corporations are included in this definition of indirect interest. In addition, interests in a partnership, trust, or estate, to the extent that the assets of such entity consist of immovable property situated in the source state, are included in this definition of indirect interest. Paragraph 13 of the Protocol makes clear that in all events the term "immovable property situated in the other Contracting State" includes a United States real

property interest when the United States is the other Contracting State. Thus, the United States preserves its right to collect the tax imposed by section 897 of the Code on gains derived by foreign persons from the disposition of United States real property interests. For this purpose, the source rules of section 861(a)(5) of the cede shall determine whether a United States real property interest is situated in the United States.

Because the definition of "immovable property situated in the other Contracting State" contained in paragraph 2 of Article 13 is specifically limited to Article 13, such definition has no effect on the right to tax income covered in other articles. For example, the inclusion of interests in certain corporations in the definition of immovable property situated in the other Contracting State for purposes of permitting source country taxation of gains derived from dispositions of such interests under Article 13 does not affect the treatment of dividends paid by such corporations. Such dividends remain subject to the limitations on source country taxation contained in Article 10 (Dividends) and are not governed by the unlimited source country taxation right contained in Article 6 with respect to immovable property.

In the case of gains from the alienation of movable property, paragraph 3 of Article 13 preserves the source country right to tax in certain circumstances. It provides that gains from the alienation of 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 movable 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, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State. Paragraph 14 of the Protocol makes clear that nothing in Article 13 is intended to prevent gains from the alienation by a resident of a Contracting State of an interest in a partnership, trust, or estate that has a permanent establishment situated in the other Contracting State from being taxed as gains attributable to such permanent establishment under paragraph 3 of Article 13. Thus, for example, the United States may tax gains derived from the disposition of an interest in a partnership that has a permanent establishment in the United States, regardless of whether the assets of such partnership consist of immovable property as defined in Article 13.

Paragraph 4 provides that gains 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 shall be taxable only in the Contracting State in which the profits of the enterprise deriving such income are taxable according to Article 8 (Shipping and Air Transport). Generally, Article 8 exempts such income from source country taxation.

Subject to the special rule of paragraph 6, paragraph 5 grants to the residence State the exclusive right to tax gains from the alienation of other than property referred to in paragraphs 1 through 4.

Paragraph 6 provides an exception to the general exemption from source country tax contained in paragraph 5 for gains derived by certain individuals from its alienation of shares forming part of a 25 percent interest in a company resident in the source state. Under this rule, if an individual was a resident of a Contracting State and, after giving up residency in that State,

becomes a resident of the other Contracting State under the rules of Article 4 (Residency), and such individual derives gains from the disposition of a 25 percent interest in a company that is a resident in the first-mentioned Contracting State, the first-mentioned State may tax such gain under its national law, provided the alienation giving rise to the gain occurs within ten years of the date on which the individual gave up residence in the first-mentioned State. Gains subject to source country taxation under this special rule are limited to gains accrued during the period the individual was a resident of the first-mentioned State. For purposes of imposing its own tax on such gains, the residence state will calculate gain by reference to the value of the shares on the date the individual ceased to be a resident of the first-mentioned State. In the case of a person giving up German residence and becoming a resident of the United States, this will be accomplished by stepping up the basis of the individual in the shares to the value of such shares on the date such individual ceased to be a resident of Germany. Such a basis step-up is only required to the extent any gain is actually subject to tax in the Federal Republic of Germany.

For example, if an individual resident of Germany acquires a 25 percent interest in a German company for $ 100 while a resident of Germany, ceases to be a resident of Germany when the stock is worth $150, and sells the stock for $200 after becoming a resident of the United States and within 10 years of the date he ceased to be a German resident, Germany retains the right to tax the $50 gain that accrued while the individual was a resident of Germany. For purposes of calculating U.S. tax on the gain, the United States will step up the individual's cost basis in the stock to $150 (the value on the date the individual ceased to be a resident of Germany) and impose its tax only on the $50 gain that accrued after the individual ceased to be a resident of Germany. If the alienation occurs more than 10 years after the individual gave up German residency, Germany will waive its statutory right to tax the full gain. The special rule of paragraph 6 also affects the taxation of former residents of the United States who dispose of stock in U.S. companies while resident in Germany.

Notwithstanding the foregoing limitations on source country taxation of certain gains, subparagraph (a) of Paragraph 1 of the Protocol permits the United States to tax its citizens and residents as if the Convention had not come into effect. The rules of paragraph 6 of this Article, however, continue to apply to U.S. citizens and residents by virtue of the exceptions to the saving clause in subparagraph (b)(aa) of Paragraph 1 of the Protocol.

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 dependent personal service income. Exceptions or additions to these general rules are found in Articles 16 through 20 for directors' fees (Article 16); performance income of artistes and athletes (Article 17); pensions in respect of personal service income, annuities, alimony, and child support payments (Article 18); government service salaries and pensions and social security benefits (Article 19); and the income of visiting professors and teachers, and students and trainees (Article 20).

Article 14 provides the general rule that an individual who is a resident of a Contracting State and who derives income from the performance of personal services in an independent capacity will be exempt from tax in respect of that income by the other Contracting State unless certain conditions are satisfied. The income may be taxed in the other Contracting State if the services are performed there and the income is attributable to a fixed base which is regularly available to the individual in that other State for the purpose of performing his services. If, however, the individual is a German resident who performs independent personal services in the United States, and he is also a U.S. citizen, the United States may, by virtue of the saving clause of subparagraph (a) of Paragraph 1 of the Protocol, tax his income without regard to the restrictions of this Article, subject to the special foreign tax credit rules of paragraph 3 of Article 23 (Relief from Double Taxation).

The term "fixed base" is not defined in the Convention, but its meaning is understood to be analogous to that of the term "permanent establishment", as defined in Article 5 (Permanent Establishment). Similarly, some rules of Article 7 (Business Profits) for attributing income and expenses to a permanent establishment are relevant for attributing income to a fixed base. However, the taxing right conferred by this Article with respect to income from independent personal services is somewhat more limited than that provided in Article 7 for the taxation of business profits. 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 in order for that other State to have a taxing right. In Article 14, in addition, the income 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.

Paragraph 2 notes that the term "personal services in an independent capacity" includes independent scientific, literary, artistic, educational or teaching activities, as well as the independent activities of physicians, lawyers, engineers, economists, architects, dentists, and accountants. This list is clearly not exhaustive. The term includes all personal services performed by an individual for his own account, whether as a sole proprietor or a partner, where he receives the income and bears the risk of loss arising from the services. Income from services in which capital is a material income producing factor will, however, generally be governed by the provisions of Article 7 (Business Profits). The taxation of income of an individual from those types of independent services which are covered by Articles 16 through 20 is governed by the provisions of those Articles.

Paragraph 3 of the Protocol refers to this Article as well as Article 5. The Paragraph provides that a resident of a Contracting State that engages in artistic performances in the other Contracting State and is not subject to tax in that other State under the provisions of Article 17 (Artistes and Athletes), will not be deemed to have a fixed base (or permanent establishment) in that other State if the person's presence there does not exceed 183 days in the calendar year.

There is no special rule in the Protocol with respect to this Article comparable to Paragraph 4 of the Protocol which is applicable to Articles 7 (Business Profits) and 13 (Gains). That rule clarifies that income which is attributable to a permanent establishment, but is deferred and received after the permanent establishment no longer exists, may nevertheless be taxed by the State in which the permanent establishment was located. An analogous rule applies with

respect to Article 14, under which 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 there available to the resident. It was not considered necessary to specify this rule in the Protocol with respect to Article 14 because there is nothing in the text of the Article which requires that the performance of services and the receipt of income be in the same time frame.

The taxing rule in paragraph I of the Article differs from that in the 1954 Convention. Under Article X of the 1954 Convention the host State may tax income from independent personal services performed by a resident of the other State only if the person performing the services is present in the host State for a period or periods aggregating more than 183 days in the taxable year or is under contract with a person not resident in the taxpayer's State of residence.

ARTICLE 15
Dependent Personal Services

This Article deals with the taxation of remuneration derived by a resident of a Contracting State as an employee.

Under paragraph 1, remuneration derived by an individual who is a resident of a Contracting State as an employee may be taxed by his State of residence. To the extent his remuneration is derived from an employment exercised in the other Contracting State, the remuneration may also be taxed by that other Contracting State, subject to the conditions specified in paragraph 2. Consistent with the general rule of construction that the more specific rule takes precedence over the more general, income dealt within Articles 16 (Directors' Fees), 17 (Artistes and Athletes), 18 (Pensions, Annuities, Alimony and Child Support), 19 (Government Service; Social Security), and 20 (Visiting Professors and Teachers; Students and Trainees) is governed by the provisions of those Articles rather than this Article.

Under paragraph 2, even where the remuneration of a resident of a Contracting State (described in paragraph 1 is derived from sources within the other Contracting State (i.e., the services are performed there), that other State may not tax the remuneration if three conditions are satisfied:

(1) the individual is present in the other Contracting State for a period or periods not exceeding 183 days in the calendar year;

(2) the remuneration is paid by, or on behalf of, an employer who is not a resident of that other Contracting State; and

(3) the remuneration is not borne as a deductible expense by a permanent establishment or fixed base that the employer has in that other State.

If a foreign employer pays the salary of an employee, but a host country corporation or permanent establishment reimburses the foreign employer in a deductible payment which can be identified as a reimbursement, neither condition (2) nor (3), as the case may be, will be considered to have been fulfilled. Conditions (2) and (3) are intended to assure that a Contracting

State will not be required both to allow a deduction to the payor for the amount paid and to exempt the employee on the amount received. In order for the remuneration to be exempt from tax in the source State, all three conditions must be satisfied.

Paragraph 3 contains a special rule applicable to remuneration for services performed by an individual who is a resident of a Contracting State as an employee aboard a ship or aircraft operated in international traffic. Such remuneration may be taxed only in the Contracting State of residence of the employee if the services are performed as a member of the regular complement of the ship or aircraft. The "regular complement" includes the crew. In the case of a cruise ship, it may also include others, such as entertainers, lecturers, etc., employed by the shipping company to serve on the ship. The use of the term "regular complement" is intended to clarify that a person who exercises his employment as, for example, an insurance salesman while aboard a ship or aircraft is not covered by this paragraph.

The comparable paragraph in the OECD Model provides a different rule. Under paragraph 3 in the OECD Model such income may be taxed (on a non-exclusive basis) in the Contracting State in which the place of effective management of the employing enterprise is situated. The United States does not use this rule in its Model, because under U.S. law, a taxing right over an employee of an enterprise managed in the United States (or an employee of a U.S. resident) cannot be exercised with respect to non-U.S. source income unless the employee is also a U.S. citizen or resident.

If a U.S. citizen who is resident in Germany performs dependent services in the United States and meets the conditions of paragraph 2, or is a crew member on a German ship or airline, and would, therefore, be exempt from U.S. tax were he not a U.S. citizen, he is, nevertheless, taxable in the United States on his remuneration by virtue of the saving clause of subparagraph (a) of Paragraph 1 of the Protocol, subject to the special foreign tax credit rule of paragraph 3 of Article 23 (Relief from Double Taxation).

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 in that State by a 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, for example, in determining whether a non-employee 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 U.S. Model has no comparable provision. The preferred U.S. policy is to treat a corporate director in the same manner as any other individual performing personal services-outside directors would be subject to the provisions of Article 14 (Independent Personal Services) and inside directors would be subject to the provisions of Article 15 (Dependent Personal Services). The preferred German position, on the other hand, is that reflected in the

OECD Model, in which a resident of one Contracting State who is a director of a corporation which 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. The provision in Article 16 of the Convention represents a compromise between these two positions. The State of residence of the corporation may tax nonresident directors with no threshold, but only with respect to remuneration for services performed in that State.

This Article is subject to the saving clause of subparagraph (a) of Paragraph 1 of the Protocol. Thus, if a U.S. citizen who is a German resident is a director of a U.S. corporation, the United States may tax his full remuneration regardless of the place of performance of his services.

The 1954 Convention contains no special rule dealing with corporate directors. They are subject to the normal rules regarding the taxation of persons performing personal services.

ARTICLE 17
Artistes and Athletes

This Article deals with the taxation in a Contracting State of artistes (i.e., performing artists and entertainers) and athletes 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 athlete who performs services on his own behalf and one who performs his 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, however, only with respect to the income of performing artists and athletes. Others involved in a performance or athletic event, such as producers, directors, technicians, managers, coaches, etc., remain subject to the provisions of Articles 14 and 15.

Paragraph 1 describes the circumstances in which a Contracting State may tax the performance income of an entertainer or athlete who is a resident of the other Contracting State. Under the paragraph, income derived by a resident of a Contracting State from his personal activities as an entertainer or athlete exercised in the other Contracting State may be taxed in that other State if the amount of the gross receipts derived by the individual exceeds $20,000 (or its equivalent in Deutsche Mark) for the calendar 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.

The OECD Model provides for taxation by the country of performance of the remuneration of entertainers or athletes with no dollar or time threshold. The United States introduces the dollar threshold test in its treaties 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 only modest amounts and are, therefore, not clearly distinguishable from those who earn other types of personal service income.

Paragraph 1 applies notwithstanding the provisions of Articles 7 (Business Profits), 14 (Independent Personal Services) or 15 (Dependent Personal Services). Thus, if an individual would otherwise be exempt from tax under those Articles, but is subject to tax under this Article, he may be taxed. An entertainer or athlete who receives less than the $20,000 threshold amount, and who is, therefore, not affected by this Article, may, nevertheless, be subject to tax in the host country under Articles 14 or 15 if the tests for taxability under those Articles are met. For example, if an entertainer who is an independent contractor earns only $19,000 of income for the calendar year, but the income is attributable to a fixed base regularly available to him in the State of performance, that State may tax his income under Article 14.

Since it is frequently not possible to know until year end whether the income an entertainer or athlete derived from performance 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. Paragraph 15 of the Protocol specifically authorizes Germany to withhold tax on an entertainer or athlete. If, at the end of the year, it is determined that the entertainer or athlete is not subject to German tax under the provisions of paragraph 1 of the Article, Germany is obligated to refund the tax withheld only upon application at the end of the calendar year concerned.

Income derived from a Contracting State by an entertainer or athlete who is a resident of the other Contracting State in connection with his activities as such, but 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, as appropriate, such as Article 12 (Royalties) or Article 14 (Independent Personal Services). For example, if an entertainer receives royalty income from the sale of recordings of a concert given in a State, the royalty income would be exempt from source country tax under Article 12, even if the remuneration from the concert itself may have been covered by this Article. In this connection, see Paragraph 12 of the Protocol, and the discussion of it in the technical. explanation of Article 12 (Royalties).

Paragraph 2 is intended to deal with the potential for abuse when income from a performance by an entertainer or athlete does not accrue to the performer himself, but to another person. Foreign entertainers commonly 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 entertainer's performance. The entertainer may be acting as an "employee", receiving a modest salary, and arranging 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 company providing the entertainer's services can escape host country tax because it earns business profits but has no permanent establishment in that country. The entertainer 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. He would arrange to receive further payments in a later year, when lie is not subject to host country tax, perhaps as 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 persons related to him) participate, directly or indirectly, in the 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 entertainer or athlete. This paragraph does not affect the rules of paragraph 1, which apply to the entertainer or athlete himself. To the extent of salary payments to the performer, which are treated under paragraph 1, the income taxable by virtue of paragraph 2 to the person providing his services is reduced.

For purposes of paragraph 2, income is deemed to accrue to another person (i.e., the person providing the services of the entertainer or athlete) if that other person has control over, or the right to receive, gross income in respect of the services of the entertainer or athlete. 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.

The paragraph 2 override of the protection of Articles 7 (Business Profits) and 14 (Independent Personal Services) does not apply if it is established that neither the entertainer or athlete, nor any persons related to the entertainer or athlete, participate directly or indirectly in the profits of the person providing the services of the entertainer or athlete. Thus, for example, if a circus owned by a U.S. corporation performs in Cologne, the German promoters of the performance pay the circus, which, in turn, pays salaries to the clowns. The circus has no permanent establishment in Germany. Since the clowns 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 German tax. Whether the salaries of the clowns are subject to German tax depends on whether they exceed the $20,000 threshold in paragraph 1. This exception for non-abusive cases to the paragraph 2 override of the Articles 7 and 14 protection of persons providing the services of entertainers and athletes is not found in the OECD Model. The policy reflected in this exception is, however, consistent with the stated intent of Article 17 of that Model, as indicated in its Commentaries. The Commentaries to Article 17 state that paragraph 2 is intended to counteract certain tax avoidance devices, in which income is diverted from the performer to another person in order to minimize the total tax on the remuneration. It is, therefore, consistent not to apply these rules in non-abusive cases.

Paragraph 3 of the Article is not found in the U.S. or OECD Models. It was introduced at the suggestion of Germany. It 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 athlete who is a resident of the other Contracting State, if the visit is substantially supported, directly or indirectly, by the public funds of his State of residence or of a political subdivision or local authority of that State. In the

circumstances described, only the Contracting State of residence of the entertainer or athlete may tax his income from the performances so supported in the other State.

This Article is subject to the provisions of the saving clause of subparagraph (a) of Paragraph 1 of the Protocol. Thus, if an entertainer or athlete who is resident in Germany is a citizen of the United States, the United States may tax all of his income from performances in the United States without regard to the provisions of this Article, subject, however, to the special foreign tax credit provisions of paragraph 3 of Article 23 (Relief from Double Taxation).

The 1954 Convention contains no special rules for the taxation of the income of entertainers and athletes. Such income is subject to the general rules for the taxation of personal service income.

ARTICLE 18
Pensions, Annuities, Alimony and Child Support

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

Paragraph 1 provides that private 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 recipient. This rule applies to both periodic and lump-sum payments. Treatment of such pensions under the 1954 Convention is essentially the same as under this Convention. The rules of this Article do not apply to items of income which are dealt within Article 19 (Government Service; Social Security), including pensions in respect of government service, or as compensation for injury or damage sustained in hostilities, and social security benefits.

Under paragraph 2, annuities (other than those annuities which are dealt within Article 19 (Government Service; Social Security)) which 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 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). Annuities are similarly treated under the 1954 Convention.

Paragraphs 1 and 2 of Article 18 are subject to the saving clause of subparagraph (a) of Paragraph 1 of the Protocol.

Paragraphs 3 and 4 deal with alimony and child support payments. The provisions of the two paragraphs differ, in some respects, from the comparable provisions in the U.S. Model, in order to be able to mesh more completely the provisions of U.S. and German law regarding the treatment of such payments. Paragraph 3 deals only with those alimony payments which are deductible to the payor. Under the paragraph, alimony paid by a resident of a Contracting State, to the extent it is deductible by that resident, to a resident of the other Contracting State is taxable only in the State of residence of the recipient. Paragraph 4 deals with nondeductible

alimony and periodic payments for the support of a minor child. These types of payments by a resident of a Contracting State to a resident of the other Contracting State are taxable only in the State of residence of the payor.

Both alimony, under paragraph 3, and nondeductible alimony and child support payments, under paragraph 4, are defined as periodic payments made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support. In addition, for a payment to be treated as "alimony" for purposes of this Article, it must be taxable to the recipient under the laws or his State of residence.

Under U.S. law, alimony is generally deductible to the payor and taxable in the hands of the recipient. Such payments made by U.S. residents, therefore, fall within the terms of paragraph 3, and are taxable only in Germany. German law provides for deductibility of the first DM 18,000 of alimony payments annually, if the payment is to a person subject to unlimited tax liability in Germany. To the extent alimony is deducted by the payor, it is taxable under German law to the recipient. German alimony payments, to the extent they exceed DM 18,000, are not deductible to the payor and the recipient is not subject to German tax. Thus, some alimony paid by German residents fall under paragraph 3 and some falls under paragraph 4.

Since, under German law, the first DM 18,000 of alimony is deductible to the payor only if the payee is subject to unlimited German tax liability, no alimony payments to a U.S. resident are deductible under German law. Paragraph 16 of the Protocol provides that for purposes of paragraph 3 of the Article, if a German resident pays alimony to a U.S. resident, the payor shall be allowed a deduction for German tax purposes to the same extent that a deduction would be allowed if the payment were made to a person who is subject to unlimited tax liability in Germany.

The saving clause of subparagraph (a) of Paragraph 1 of the Protocol does not apply to paragraphs 3 and 4. The benefits of these paragraphs, therefore, are not overridden by any contrary provisions of the Code. Thus, if, for example, a U.S. citizen who is a resident in Germany receives an alimony payment from a U.S. resident, that payment is exempt from U.S. tax under paragraph 3 of the Article, notwithstanding the existence of a tax liability under the Code.

ARTICLE 19
Government Service; Social Security

Subparagraphs (a) and (b) of paragraph 1 deal with the taxation of government compensation and pensions (other than social security pensions, which are dealt within paragraph 2). Subparagraph (a) provides that wages, salaries, and similar compensation and pensions paid by the United States or by its states or political subdivisions to any individual are exempt from German tax unless the payee is a German national. Under subparagraph (b), such payments by Germany, or by its Laender (i.e., states) or by municipalities or by a public pension fund of such governments to any individual are exempt from U.S. tax unless the payee is a U.S. citizen or a green card holder. Subparagraph (d) of paragraph 1 specifies that the term "pensions"

includes annuities paid to retired civilian government employees.

These provisions differ in several respects from those in the U.S. and OECD Models. Most significantly, unlike the provisions in those Models, Article 19 of the Convention does not exclude payments in respect of services rendered in connection with a business carried on by the governmental entity paying the compensation or pension. It is not the policy of the German Government for governmental entities to engage in business activities. The provisions of Article 19 are identical to those in the 1954 Convention. Under that Convention there have been no cases of benefits being claimed under the government services provisions for services of a business nature.

Subparagraph (c) of paragraph 1 contains a provision proposed by Germany. It is identical to a provision in the 1954 Convention. The subparagraph provides that amounts paid by a Contracting State or by a juridical person organized under the public laws of that State which are compensation for injury or damage sustained as a result of hostilities or political persecution are exempt from tax in the other Contracting State. Although the subparagraph is drafted reciprocally, it is intended to provide U.S. exemption for German war reparation payments.

Paragraph 2 deals with the taxation of social security benefits and similar public pensions. This includes the benefits paid under the social security legislation of both Contracting States and certain U.S. Railroad Retirement benefits. It does not include pensions for government service, which are dealt within paragraph 1. Under paragraph 2, such benefits paid by a Contracting State to a resident of the other Contracting State are taxable only in the State of residence of the recipient. In applying its tax, the State of residence will treat the benefit as though it were a benefit paid to a resident under its own social security system. Thus, for example, if a U.S. resident receives a German social security benefit, he would include only one half of the benefit or such other portion as he would if the benefit had been a U.S. social security or railroad retirement benefit. The treatment of social security benefits in the Convention differs from that in the U.S. Model, under which the source State retains a taxing right.

Subparagraph 1(c) and paragraph 2 of this Article are exceptions to the saving clause of subparagraph (a) of Paragraph 1 of the Protocol (as indicated in sub-subparagraph (b)(aa) of that Paragraph). Thus, a U.S. citizen or resident who receives German reparations payments would not be subject to any U.S. tax on that payment, regardless of whether he would be taxable under the Code. Similarly, a U.S. citizen who is resident in Germany and receives U.S. social security benefits would be exempt from U.S. tax on those benefits. The saving clause does not apply to the benefits conferred by subparagraphs (a) and (b) of paragraph 1 of the Article (as provided in sub-subparagraph (b)(bb)) of Paragraph 1 of the Protocol) with respect to a resident of the United States who is neither a U.S. citizen nor a green card holder. Thus, for example, if a German Government employee is temporarily present in the United States for his employment, and is present in the United States for a sufficient time under an appropriate visa to become a resident of the United States under the Code, but does not acquire immigrant status in the United States, he would not be subject to U.S. tax on his German Government salary. If, however, he acquires immigrant status, he would be subject to U.S. tax, notwithstanding the provisions of Article 19.

ARTICLE 20

Visiting Professors and Teachers; Students and Trainees

Paragraph 1 of the Article deals with visiting professors and teachers. Paragraphs 2 through 5 deal with students, apprentices and trainees. Paragraph 1 provides that if a professor or teacher who is, and remains, a resident of one Contracting State visits the other Contracting State for a period not exceeding two years for the purpose of teaching or carrying out advanced study or research at certain categories of institutions, he will be exempt from tax in the State which he is visiting (the "host State") on his compensation for such teaching, study or research. The host State exemption will apply if the teaching, study or research is carried on at an accredited university, college, school or other educational institution, or at a public research institution or other institution engaged in research for the public benefit. The term "public research institution" is intended to cover such institutions as the National Institutes of Health in the United States.

For the exemption 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. A person is not entitled to the benefits of this paragraph if he has, during the immediately preceding period, enjoyed the benefits of paragraphs 2, 3 or 4 of this Article as a student, apprentice or trainee. If, however, following the period in which a person claimed student benefits under paragraphs 2, 3, or 4, that person resumes residence and physical presence in his original home State before returning to the host State as a teacher or researcher, he may claim the benefits of paragraph 1. As clarified in Paragraph 18 of the Protocol, unless the competent authorities agree otherwise, if a professor or teacher remains in the host country for more than the specified two year period, he may be subject to tax in that State, under its law, for the entire period or his presence.

There is no provision in the U.S. or OECD Models dealing with professors or teachers. It is not standard U.S. treaty policy to provide benefits to visiting teachers by treaty. When, however, the treaty partner wishes to include such a provision, the United States will frequently agree, particularly, as in this case, when an existing Convention with that partner contains a similar provision (see Article XII of the 1954 Convention).

Paragraph 2 deals with payments, other than compensation for personal services, received by a student or business apprentice. If a student or business apprentice is present in the host State for the purpose of his full-time education or training, and he was a resident of the other Contracting State immediately before his visit, he will be exempt from tax in the host State on payments (other than compensation for personal services) arising from sources, or remitted from, outside the host State, which are for the purpose of the student's or trainee's maintenance, education or training.

Article XIII of the 1954 Convention and Article 20 of the OECD Model contain similar provisions. Both of these, however, refer to a student who is present "solely" for purposes of his education or training. The Convention refers, instead, to one who visits for the purpose of his "full-time education or training". This change in language from the 1954 Convention is intended to clarify that even if the student engages in other activities in the host State, such as part-time employment (and might therefore be regarded as not present *solely* for his education), he remains

eligible for the benefits of the Article as long as lie is a full-time student or apprentice.

Paragraph 17 of the Protocol relates to paragraph 2 of the Article. It clarifies that payments from public funds of a Contracting State or from scholarship organizations endowed with such public funds will be treated as arising from sources outside the other Contracting State for purposes of the exemption provided in paragraph 2, when that other State is the host State. Under Paragraph 17 of the Protocol, such payments will also be considered to arise in full from sources outside the host State when payments are made under programs jointly funded by organizations of both Contracting States, so long as more than 50 percent of the combined funds is provided from the public funds of the Contracting State which is not the host State, or by a scholarship organization endowed with such funds.

Paragraph 3 of the Article provides that when a person visits a Contracting State, and that person is, or was immediately before the visit, a resident of the other Contracting State, he will not be taxed in the host State on payments (other than compensation for personal services) which he receives as a grant, allowance or award from a non-profit religious, charitable, scientific, literary, or educational private organization, including those organized in the host State, or a comparable public institution. This exemption applies regardless of the residence of the institution making the grant or award. This provision is broader in scope than the provisions of the student and scholar articles of most U.S. treaties. It is intended to apply, for example, to persons such as authors, composers, dramatists, etc. whose visits and work are funded by such grants, even though the recipients may not be engaged in formal study or research. This provision is essentially the same as paragraph 3 of Article XIII of the 1954 Convention.

Paragraph 4 provides that persons covered by paragraphs 2 and 3 (i.e., qualified students and business apprentices and recipients of certain grants, allowances or awards) who remain in the host country for a period not exceeding 4 years will be exempt from host country tax on income from dependent personal services not in excess of $5,000 (or its equivalent in Deutsche Mark) per taxable year. The exemption applies only if the services are performed solely for the purposes of supplementing the funds otherwise available for the person's maintenance, education or training. The $5,000 exemption applies in addition to, and not in lieu of, any allowances (e.g., personal exemptions and standard deductions) available to the person under the internal laws of the Contracting States. If the amount earned exceeds $5,000 per annum, only the excess is taxable. Under the provisions of Paragraph 18 of the Protocol, if the stay in the host State exceeds four years, the person may be subject to tax there for the entire period, unless the competent authorities agree otherwise. The exemption provision of paragraph 4 does not apply to income from the performance of independent personal services.

Paragraph 5 deals with a resident of a Contracting State who is an employee of an enterprise of that State or of an organization described in paragraph 3, who is temporarily present in the other Contracting State for a period not exceeding one year for the sole purpose of acquiring technical, professional or business experience from a person other than his employer. Such resident will be exempt from tax by the host State on compensation for services, wherever performed, which is remitted from outside that State and paid by such organization or institution if the compensation does not exceed $10,000. Unlike the exemption provided in paragraph 4, this exemption does not apply at all if the compensation exceeds $10,000.

By virtue of the exception to the saving clause in sub-subparagraph (b)(bb) of Paragraph 1 of the Protocol, the saving clause does not apply with respect to a person entitled to U.S. benefits under the provisions of this Article if that person is neither a U.S. citizen nor has immigrant status in the United States. Thus, for example, a German resident who visits the United States as a student or professor and becomes a U.S. resident according to the Code, would continue to be exempt from U.S. tax in accordance with this Article so long as he is not a U.S. citizen and does not acquire immigrant status in the United States. The saving clause does apply to U.S. citizens and immigrants.

ARTICLE 21
Other Income

This Article provides the rules for the taxation of items of income not dealt within the other articles of the Convention. An item of income is "dealt with" in an article when an item in the same category is a subject of the article, whether or not any treaty benefit is granted to that item of income. This Article deals both with classes of income which are not dealt with elsewhere, such as, for example, lottery winnings, and with income of the same class as income dealt within another article of the Convention, but from sources in third States, and, therefore, not a subject of the other Article, if that article deals only with items of that class of income from sources within a Contracting State. Paragraph 1 contains the general rule that such items of income derived by a resident of a Contracting State will be taxable only in the State of residence. This exclusive right of taxation applies irrespective of whether the residence State exercises its right to tax the income covered by the Article.

Paragraph 2 contains an exception to the general rule of paragraph 1 for income, other than income from real property, which 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). Thus, in general, third-country income which is attributable to a permanent establishment maintained in the United States by a resident of Germany would be taxable by the United States. There is an exception to this rule for income from real property, as defined in paragraph 2 of Article 6 (Income from Immovable (Real) Property). If a German resident derives income from real property located outside the United States which is attributable to the resident's permanent establishment or fixed base in the United States, only Germany and not the United States may tax that income. This special rule for foreign situs real property is consistent with the general rule, also reflected in Articles 6 (Income from Immovable (Real) Property) and 22 (Capital), 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 if neither the situs of the property nor the residence of the owner is in that State.

Paragraph 19 of the Protocol relates to paragraph 2 of the Article. It provides a special rule for the case where a German corporation pays a dividend to a resident of Germany and the dividend is attributable to a permanent establishment or fixed base which the resident maintains

in the United States. This dividend is an item of income which is not dealt within Article 10 (Dividends), because Article 10, by its terms, applies to dividends paid by a resident of one Contracting State to a resident of the other. In the case dealt within Paragraph 19, Germany will treat the dividend as if it were paid to a resident of the United States, i.e., it may impose tax, but must limit its tax to the rates provided for in paragraphs 2 and 3 of Article 10 (Dividends). The United States may tax the dividend as income attributable to the permanent establishment or fixed base, but must give credit in accordance with tile provisions of Article 23 (Relief from Double Taxation).

This Article is subject to the saving clause of subparagraph (a) of Paragraph 1 of the Protocol. Thus, the United States may tax the income of a German resident not dealt with elsewhere in the Convention, if that German resident is a citizen of the United States.

ARTICLE 22
Capital

This Article specifies the circumstances in which a Contracting State may impose tax on capital owned by a resident of the other Contracting State. Since the United States does not impose taxes on capital, tile only capital taxes covered by the Convention are those imposed by Germany. Thus, although the Article is drafted in a reciprocal manner, its provisions are relevant only for the imposition of German tax. The explanation which follows will be from the perspective of Germany as the taxing State. The Article was included at Germany's request. It provides essentially the same rules as Article XIV A of the 1954 Convention.

The Article provides the general rule in paragraph 4 that capital owned by a resident of a Contracting State may be taxed only by that Contracting State. Thus, in general, Germany cannot tax a resident of the United States on capital owned by that resident. Exceptions to this general rule are provided in paragraphs 1, 2 and 3.

Paragraph 1 provides that capital represented by real property (as defined in Article 6 (Income from Immovable (Real) Property)) which is owned by a U.S. resident and located in Germany may be taxed by Germany. Under paragraph 2, capital which is represented by movable property which is part of the business property of a permanent establishment maintained by a U.S. resident in Germany or pertains to a fixed base maintained in Germany by a U.S. resident may be taxed by Germany.

Paragraph 3 deals with capital represented by ships, aircraft or containers operated in international traffic by an enterprise of the United States and with other movable property pertaining to the operation of such ships, aircraft or containers. Under the paragraph, such capital is taxable only in the Contracting State where the income of the U.S. enterprise owning such capital is taxable under the provisions of Article 8 (Shipping and Air Transport). Since a U.S. shipping, airline or container enterprise operating in international traffic is exempt from German income tax, such capital is also exempt from capital tax in Germany.

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 exclusively. Germany uses a combination of foreign tax credit and exemption methods, depending on the nature of the income involved.

In paragraph 1, the United States agrees to allow to its citizens and residents a credit against U.S. tax for income taxes paid or accrued to Germany. 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.

Paragraph 1 also provides for a deemed-paid credit, consistent with section 902 of the Code, to a U.S. corporation in respect of dividends received from a German corporation in which the U.S. corporation owns at least 10 percent of the voting shares. This credit is for the tax paid by the German corporation on the earnings out of which the dividends are considered paid.

As indicated, the U.S. credit under the Convention is subject to the limitations of U.S. law, which generally limit the credit against U.S. tax 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)). Nothing in the Convention prevents the limitation of the U.S. credit from being applied on a per-country or overall basis or on some variation thereof. In general, where source rules are provided in the Convention for purposes of determining the taxing rights of the Contracting States, these are consistent with the Code source rules for foreign tax credit and other purposes. Where, however, there is an inconsistency between Convention and Code source rules, the Code source rules (e.g., Code section 904(g)) will be used to determine the limits for the allowance of a credit under the Convention. (Paragraph 3 of the Article provides an exception to this general rule with respect to certain U.S. source income of U.S. citizens resident in Germany.)

Paragraph 1 also provides that the German income taxes specified in subparagraph 1(b) and paragraph 2 of Article 2 (Taxes Covered) are to be treated as income taxes for purposes of allowing a credit under the Convention. It is not U.S. policy to allow credit by treaty for taxes which are not creditable under the Code, and it was the understanding of the negotiators that each of the German income taxes specified in Article 2 for which credit is allowed under Article 23 are creditable taxes under the Code. If, however, it should prove that a credit is being allowed under the Convention for a German tax which is not a creditable income tax under the Code, paragraph I specifies that such credits shall be allowed only on a per-country basis, to the extent of U.S. tax, i.e., only on net German source income within the relevant foreign tax credit limitation category under Code section 904(a).

Paragraph 20 of the Protocol relates to paragraph 1 of Article 23. It elaborates on certain

aspects of the U.S. credit under the Convention, describing the relationship between the Code and Convention credit and source rules. All of the issues dealt within Paragraph 20 of the Protocol have been discussed above in this explanation.

Paragraph 2 of the Article provides the rules by which Germany, in imposing tax on its residents, provides relief for U.S. taxes paid by those residents. Subparagraph 2(a) specifies the general rule that (except in cases where a foreign tax credit is provided for under the provisions of subparagraph 2(b)) in imposing tax on its residents, Germany will exempt from German tax any item of income from U.S. sources or capital situated in the United States which may be taxed in the United States in accordance with the Convention. Germany may compute the exemption with progression. That is, in determining the rate of tax applicable under a progressive rate structure to the income or capital which is not exempt, Germany may take the exempt income or capital into account. The principal types of U.S. source income covered in this subparagraph, for which exemption is allowed, are

(1) income derived by a German enterprise which is attributable to a permanent establishment in the United States,

(2) many kinds of capital gains,

(3) most classes of personal services income, and,

(4) as described below, dividends from direct investments in the United States.

Paragraph 3 of Article 23 provides special rules for the tax treatment of U.S. citizens resident in Germany. These rules are narrower, with respect to the scope of Germany's double taxation relief obligations to such persons, than the provisions of subparagraph (l)(b)(2) of Article XV of the 1954 Convention. It is understood that the exemption under subparagraph 2(a) does not apply to items of income which may be taxed in the United States by solely reason only of Paragraph 1 of the Protocol (i.e., the saving clause).

Subparagraph 2(a) specifies which dividends received by German residents from U.S. sources are subject to the exemption provisions of the subparagraph. Only those dividends paid by a U.S. company to a German company which owns at least 10 percent of the voting shares of the paying company are exempt. The subparagraph clarifies that exempt dividends are those which are distributions of profits on corporate rights which are subject to tax in the United States. It also clarifies that the recipient company cannot be a partnership. Furthermore, the subparagraph specifies that, notwithstanding the general rule described above, dividends paid by a U.S. Regulated Investment Company ("RIC"), or other U.S. corporate distributions where the distribution itself is deductible in calculating the profits for tax purposes of the paying company (e.g., dividends from Real Estate Investment Trusts), are not exempt from German tax. An exchange of notes between competent authorities, subsequent to the signing of the treaty, but before its ratification, clarifies that the intent of the negotiators was as stated in the preceding sentence. When the treaty speaks of "distributions of amounts that have been deducted when calculating for United States tax purposes the profits of the company distributing them", the reference is to a dividends paid deduction, not to a dividends received deduction. For purposes of German capital tax, the exemption rules follow those for the exemption of dividends from income tax. Thus, German capital tax will not be imposed on any shareholding if any dividends which night arise from such shareholding would be exempt under the provisions of this subparagraph.

Subparagraph 2(b), which contains the exceptions to the general exemption rule of subparagraph 2(a), indicates those items of U.S. source income, which have been taxed in the United States in accordance with the provisions of U.S. law and the Convention, for which Germany will provide a foreign tax credit rather than exemption. Any income which is taxed in the United States in accordance with the Convention is deemed, for purposes of the German foreign tax credit (as well as for purposes of the exemption under subparagraph 2(a)), to be from U.S. sources. As with the U.S. credit under paragraph 1, the foreign tax credit granted by Germany under the Convention is subject to the provisions of German law regarding a credit for foreign taxes.

The items of income in respect of which a credit for U.S. tax is allowed under subparagraph 2(b) are specified in sub-sub-paragraphs as follows:

(aa) those U.S. source dividends, as defined in Article 10 (Dividends), for which exemption is not granted under subparagraph a) (e.g., portfolio dividends, RIC dividends and similar deductible or pass-through entity dividends);

(bb) gains from the alienation of immovable property described in subparagraph 2(b) of Article 13 (Gains), other than an interest in a real estate partnership (i.e., the types of assets, other than real property itself, which constitute a "U.S. real property interest", as the term is used in the Code);

(cc) directors' fees to which Article 16 (Directors' Fees) applies, received by German residents in respect of their services as directors of U.S. corporations;

(dd) income to which Article 17 (Artistes and Athletes) applies, including both the compensation of the artiste or athlete himself, dealt within paragraph 1 of Article 17, and any income, to which paragraph 2 of Article 17 applies, earned by persons providing the services of artistes and athletes;

(ee) salaries and similar compensation, and pensions paid by the United States Government or by its states or political subdivisions, as described in subparagraph 1a) of Article 19 (Government Service; Social Security), when paid to a German national;

(ff) income which would be exempt from U.S. tax under the Convention: (e.g., interest), but which is denied the benefits of the Convention and is subject to tax by virtue of Article 28 (Limitation on Benefits); and

(gg) income to which Paragraph 21 of the Protocol applies, as described below.

In the absence of the rule in sub-subparagraph (ff), such income would be fully taxable in Germany with no credit for U.S. tax. This sub-subparagraph provides for a German foreign tax credit in cases where the United States taxes solely by virtue of the Limitation on Benefits provisions.

Paragraph 21 of the Protocol elaborates on paragraph 2 of the Article by specifying circumstances in which Germany may apply a foreign tax credit with respect to an item of U.S. source income, notwithstanding the fact that the provisions of subparagraph 2(a) of Article 23 provide for exemption for such item of income. The change from exemption to credit provided by this Paragraph of the Protocol is designed to prevent unintended instances either of double taxation (sub-subparagraph (a)(aa)) or of double non-taxation or inappropriately low taxation (sub-subparagraph (a)(bb)).

Subparagraph (a) of Paragraph 21 of the Protocol deals with a circumstance in which an item of income or capital is either considered to fall under one provision of the Convention in Germany and under another in the United States or attributed to one person in the United States and to a different person in Germany (other than cases where this different attribution arises under Article 9 (Associated Enterprises) of the Convention). This role of the Protocol would apply only in cases where such conflict cannot be resolved through competent authority procedures under Article 25 (Mutual Agreement Procedure). An item of income would be considered as falling under different provisions of the Convention, for example, if interest paid by a U.S. partnership to a German corporate partner on a loan from the partner to the partnership were in the first instance characterized for U.S. purposes as exempt interest under Article 11 (Interest) of the Convention, and for German purposes as business profits attributable to a U.S. permanent establishment, exempt from German tax under subparagraph 2(a) of Article 23 of the Convention. In this example, the application of different provisions of the Convention to the same item of income would result in an inappropriate double exemption from both U.S. and German tax, subparagraph (a) of Paragraph 21 of the Protocol would permit Germany to switch over from an exemption to a credit mechanism for relieving double taxation. In effect, the switch over would permit Germany to tax the interest income in the German corporate partner's hands notwithstanding the general rule of subparagraph 2(a) of Article 23.

An example of attribution of an item of income to different persons would be the following: German resident A makes a loan to a U.S. resident, but German resident B is the usufructuary, i.e., he has the right to use the "fruit" of the loan, that is, the interest. B uses the interest income in connection with his permanent establishment in the United States. The United States would recognize A as the beneficial owner of the income, and would treat the interest as an exempt payment of U.S. source interest to a German resident under Article 11 (Interest). Germany would recognize B as the beneficial owner of the income and would treat the interest as attributable to B's permanent establishment in the United States. As such, the income would be exempt from German tax under subparagraph 2(a) of Article 23 (Relief from Double Taxation). Thus would be an inappropriate double exemption, and Germany could, under subparagraph (a) of Paragraph 21 of the Protocol, switch from exemption to credit.

Under subparagraph (b) of Paragraph 21 of the Protocol, Germany may, to the extent consistent with internal German law and after consultation with the U.S. competent authority, switch from an exemption to a credit for a particular item or items of income not covered under subparagraph (a) if it considers such a switch necessary to prevent double exemption or other arrangements for improper use of the Convention. The United States must be notified through diplomatic channels of any change in double taxation relief in Germany made pursuant to this

subparagraph. If there is a notification under subparagraph (b), the United States may characterize the income which was subject to the notification in a manner consistent with the characterization by Germany. The United States must notify Germany through diplomatic channels if there is such a change in characterization.

Subparagraph (b) was intended to deal with circumstances similar, for example, to those which arose under the 1954 Convention in connection with the treatment of dividends paid by U.S. Regulated Investment Companies ("RIC"s) to 10 percent or more German corporate shareholders in the RIC. Under that Convention, what was essentially portfolio interest could be transformed into direct investment dividends in the hands of such shareholders without the payment, directly or indirectly, of any corporate level U.S. tax by having the RIC hold the debt instrument. Dividends paid by the RIC were exempt from German tax as direct investment dividends, although as portfolio interest such amounts would have been taxable in Germany with a foreign tax credit. For U.S. tax purposes, the RIC was generally entitled to a dividend paid deduction. Had there been a differential rate of withholding tax for direct and portfolio dividends in the 1954 Convention (as in this Convention), the dividend would also have received the benefit of lower source country withholding, although the corporation paying the dividend was not subject to the generally applicable U.S. tax regime for corporations (i.e., it was entitled to a dividends paid deduction with respect to amounts distributed, regardless of whether such amounts had been previously subject to U.S. tax). Although this was identified and corrected in the Convention, the negotiators thought it wise to provide for the resolution of similar, though unforeseen, circumstances which might arise in the future. Subparagraph (b) would have permitted Germany to give a foreign tax credit rather than exempt the dividend and the United States to respond by taxing the dividends at the portfolio dividend withholding rate.

Diplomatic notes have been exchanged pursuant to the provisions of subparagraph (b) of Paragraph 21 of the Protocol to clarify that RIC and REIT dividends will be subject to credit and not exemption in Germany. A possible reading of paragraph 2 of Article 23 of the Convention might lead to the opposite conclusion. Although the negotiators did not believe that such an interpretation would be correct, the conclusion was reached that it would be prudent to exercise the authority of subparagraph (b) of Paragraph 21 to assure the correct result.

It should be emphasized that subparagraph (b) was intended to deal with cases of double exemption of income (e.g., through the granting of a dividends paid deduction to the U.S. payor of a dividend and a correlative exemption of such dividend in Germany) or other arrangements for improper use of the Convention. It was not intended to apply to cases where the profits out of which a distribution is made have been subject to the general U.S. corporate-level taxing regime. Thus, for example, the fact that a U.S. corporation pays a reduced level of U.S. corporate-level tax because of the nature or source of its income (e.g., because it is entitled to a dividends received deduction, a net operating loss carry forward, or a foreign tax credit) will not entitle Germany to switch from exemption to credit.

Any changes in treatment or characterization which may be made pursuant to subparagraph (b) can be effective only from the beginning of the calendar year following the year in which the formal notification of the change was transmitted to the other Contracting State and only when any legal prerequisites for the change in the domestic law of the Contracting State

giving the notification have been fulfilled. The change in the method of double taxation relief in Germany and any change in characterization in the United States in response need not be effective in the same year.

Paragraph 3 of the Article modifies the rules in paragraphs 1 and 2 for certain types of income derived from U.S. sources by U.S. citizens who are resident in Germany. Since U.S. citizens are subject to United States tax at ordinary progressive rates on their worldwide income, the U.S. tax on the U.S. source income of a U.S. citizen resident in Germany will often exceed the U.S. tax allowable under the Convention on an item of U.S. source income derived by a resident of Germany who is not a U.S. citizen.

Subparagraph (a) of paragraph 3 provides special German credit rules with respect to items of income for which Germany allows a foreign tax credit rather than an exemption under paragraph 2 and which are either exempt from U.S. tax or subject to reduced rates of U.S. tax when received by German residents who are not U.S. citizens. The German foreign tax credit allowed under these circumstances, to the extent consistent with German law, need not exceed the U.S. tax which may be imposed under the provisions of the Convention, other than tax imposed solely by reason of the U.S. citizenship of the taxpayer under the provisions of the saving clause of Paragraph 1 of the Protocol. Thus, for example, if a U.S. citizen resident in Germany receives U.S. source dividends, the German foreign tax credit would be limited to 15 percent of the dividend, the U.S. tax which may be imposed under subparagraph 2(b) of Article 10 (Dividends), even if the shareholder is subject (before the special U.S. foreign tax credit and source rules provided for in subparagraphs 3(b) and 3(c)) to a U.S. rate of tax of 28 percent because of his U.S. citizenship under Paragraph 1 of the Protocol. With respect to royalty or interest income, Germany would allow no foreign tax credit, because German residents are exempt from U.S. tax on these classes of income under the provisions of Articles 11 (Interest) and 12 (Royalties).

Subparagraph 3(b) deals with the potential for double taxation which can arise as a result of the absence of a full German foreign tax credit, because of subparagraph 3(a), for the U.S. tax imposed on its citizens resident in Germany. The subparagraph provides that the United States will credit the German income tax paid, after allowance of the credit provided for in subparagraph 3(a). It further provides that in allowing the credit, the United States will not reduce its tax below the amount which is allowed as a creditable tax in Germany under subparagraph 3(a). Since the income which is dealt within this paragraph is U.S. source income, special rules are required to resource some of the income as German source in order for the United States to be able to credit the German tax. This resourcing is provided for in subparagraph 3(c), which deems the items of income referred to in subparagraph 3(a) to be from German sources to the extent necessary to avoid double taxation under subparagraph 3(b).

Two examples will illustrate the application of paragraph 3 in the case of a U.S. source dividend received by a U.S. citizen resident in Germany. In both examples, the U.S. rate of tax on the German resident under Article 10 (Dividends) of the Convention is 15 percent. This is the tax which Germany must credit under subparagraph 3(a). Also in both examples the U.S. income tax rate on the U.S. citizen is 28 percent. In example I the German income tax rate on its resident (the U.S. citizen) is 25 percent, and in example II the German rate on its resident is 35 percent.

Subparagraph 3(a)	*Example I*	*Example II*
U.S. dividend declared	100.00	100.00
Notional U.S. withholding tax per Article 10	15.00	15.00
German taxable income	100.00	100.00
German tax before credit	25.00	35.00
German foreign tax credit	15.00	15.00
Net German tax after credit	10.00	20.00
Subparagraph 3(b) and 3(c)		
U.S. Income of U.S. citizen before tax	100.00	100.00
U.S. citizenship tax before credit	28.00	28.00
Notional U.S. withholding tax per Article 10	15.00	15.00
U.S. tax available for credit	13.00	13.00
Income resourced from U.S. to Germany	46.43	46.43
U.S. tax on resourced German income	13.00	13.00
U.S. credit for German tax	10.00	13.00
Subparagraph 3(a)		
Net U.S. tax after credit	3.00	0.00

In both examples, in the application of subparagraph 3(a) Germany credits a 15 percent U.S. tax against its residence tax on the U.S. citizen. In example I the net German tax after foreign tax credit is 10.00; in the second example it is 20.00. In the application of subparagraphs 3(b) and 3(c), from the U.S. tax due before credit of 28.00, the United States subtracts the amount of the U.S. source tax of 15.00, against which no foreign tax credit is to be allowed. This assures that, at a minimum, the United States will collect the tax which it is due under the Convention as the source country. This leaves, in both examples, an amount of U.S. tax against which credit for German tax may be claimed of 13.00. Initially, all of the income in these examples was U.S. source. In order for a U.S. credit to be allowed against 13.00 of U.S. tax on this income, the amount of income which, at a tax rate of 28 percent, generates a tax of 13.00 must be resourced as German source. Thus, 46.43 of income (13.00 divided by .28) is resourced. In example I, the German tax was 10.00. When this is credited against the U.S. tax on resourced German income, there is a net U.S. tax of 3.00 due after credit. In example II, the German tax was 20.00, but, because of the resourcing, only 13.00 is eligible for credit, since, under subparagraph 3(c), the amount of resourcing is limited to that necessary to avoid double taxation. Thus, even though the German tax was 20.00 and the U.S. tax available for credit was 13.00, there is no excess credit available for carryover.

Paragraph 4 provides that when a German company makes a distribution out of income derived from U.S. sources, Germany may, if appropriate in accordance with German law, impose a compensatory corporate tax on the distribution. Under German law, a German resident individual shareholder is entitled to a credit against his individual income tax for the 36 percent corporate tax imposed with respect to profits distributed to him as a dividend by a German corporation. If the profits out of which the dividend is paid have not borne a full 36 percent German tax, because, for example, of double taxation relief, Germany imposes a compensatory

tax on the corporation at the time of distribution to fund the 36 percent credit at the shareholder level. This paragraph preserves Germany's right to impose this tax even when German tax on the underlying income at the corporate level has been reduced below 36 percent by a foreign tax credit for U.S. tax.

This Article is not subject to the saving clause of subparagraph (a) of Paragraph 1 of the Protocol. 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 to discriminatory taxation in the other Contracting State. For this purpose, nondiscrimination means providing national treatment.

Paragraph 1 provides that a national of one Contracting State may not be subject to taxation or connected requirements in the other Contracting State which are different from, or more burdensome than, the taxes and connected requirements imposed upon a national of that other State in the same circumstances. 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 Germany as a German national who is in similar circumstances. The term "national" is defined for each Contracting State in subparagraph 1(h) of Article 3 (General Definitions).

Paragraph 22 of the Protocol relates to this paragraph of the Article. It states that the United States is not obligated, by virtue of paragraph 1 of the Article, to apply the same taxing regime to a German national who is not resident in the United States and a U.S. national who is not resident in the United States. The reason for this is that paragraph 1 of the Article applies only when the nationals of the two Contracting States are in the same circumstances. 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 Germany who are not United States residents. Thus, for example, Article 24 would not entitle a German national not resident in the United States to the net basis taxation of U.S. source dividends or other investment income which applies to a U.S. citizen not resident in the United States. This clarification provided in Paragraph 22 of the Protocol is found in paragraph 1 of Article 24 (Nondiscrimination) of the U.S. Model.

Paragraph 2 of the Article provides that a permanent establishment in a Contracting State of an enterprise of the other Contracting State may not be less favorably taxed in the first-mentioned State than an enterprise of that first-mentioned State which 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., which it grants to its own residents on account of their civil status or family responsibilities. Thus, if an individual resident in

Germany owns a German enterprise which 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 German resident the personal allowances for himself and his family which would be permitted to take if the permanent establishment were a sole proprietorship owned and operated by a U.S. resident.

Section 1446 of the Code imposes on any partnership with income which 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 the Convention, this obligation applies with respect to a German resident partner's share of the partnership income 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 German partnerships, since the law requires that partnerships of both domiciles withhold tax in respect of the partnership shares of non-U.S. partners. In distinguishing between U.S. and German partners, the requirement to withhold on the German 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 may otherwise be difficult for the United States to enforce its tax jurisdiction. If tax has been overwithheld, 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 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 under the same conditions as if the payment had been made 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 4 of Article 11 (Interest) or paragraph 4 of Article 12 (Royalties) apply, because all of these provisions permit the denial of deductions in certain circumstances in respect of transactions between related persons. The term "other disbursements" is understood to include a reasonable allocation of executive and general administrative expenses, research and development expenses an(l other expenses incurred for the benefit of a group of related persons which 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 most purposes, the Convention covers only German, and not U.S., capital taxes, under paragraph 6 of this Article, the nondiscrimination provisions apply to all taxes levied in the U.S. and Germany, at all levels of government. Thus, this provision may be relevant for U.S. as well as German tax purposes, because of taxes on capital, such as real property taxes, levied by state and local governments in the United States.

Paragraph 4 requires that a Contracting State not impose other or more burden-some taxation or connected requirements on an enterprise of that State which 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 which it imposes on other similar enterprises of that first-mentioned Contracting State.

The Tax Reform Act of 1986 (“TRA”) introduced section 367(e)(2) of the Code which changed the rules for taxing corporations on certain distributions they make in liquidation. Prior to the TRA, corporations were not taxed on distributions of appreciated property in complete liquidation, although non-liquidating distributions of the same property, with several exceptions, resulted in corporate-level tax. In part to eliminate this disparity, the law now generally taxes corporations on the liquidating distribution of appreciated property. The Code provides an exception in the case of distributions by 80 percent or more controlled subsidiaries to their parent corporations, on the theory that the built-in gain in the asset will be recognized when the parent sells or distributes the asset. This exception does not apply to distributions to parent corporations which are tax-exempt organizations or, except to the extent provided in regulations, foreign corporations. The policy of the legislation is to collect one corporate-level tax on the liquidating distribution of appreciated property; if and only if that tax can be collected on a subsequent sale or distribution does the legislation defer the tax. It is understood that the inapplicability of the exception to the tax on distributions to foreign parent corporations does not conflict with paragraph 4 of the Article. While a liquidating distribution to a U.S. parent will not be taxed, and, except to the extent provided in regulations, a liquidating distribution to a foreign parent will, paragraph 4 merely prohibits discrimination among corporate taxpayers on the basis of U.S. or foreign stock ownership. Eligibility for the exception to the tax on liquidating distributions for distributions to non-exempt, U.S. corporate parents is not based upon the nationality of the owners of the distributing corporation, but rather is based upon whether such owners would be subject to corporate tax if they subsequently sold or distributed the same property. Thus, the exception does not apply to distributions to persons which would not be so subject-not only foreign corporations, but also tax exempt organizations.

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 35 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. The provisions also 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 of the Article specifies that no provision of the Article will prevent either Contracting State from imposing the branch tax described in paragraph 8 of Article 10 (Dividends). Thus, even if the branch tax were judged to violate the provisions of paragraphs 2 or 4 of the Article, neither Contracting State would be constrained from imposing the tax.

As noted above, notwithstanding the specification of taxes covered by the Convention in Article 2 (Taxes Covered), 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.

The saving clause of subparagraph (a) of Paragraph 1 of the Protocol does not apply to this Article, by virtue of the exceptions in subparagraph (b). Thus, for example, a U.S. citizen who is resident in Germany may claim benefits in the United States under this Article.

ARTICLE 25
Mutual Agreement Procedure

This Article provides for cooperation between the competent authorities of the Contracting States to resolve disputes which may arise under the Convention and to resolve cases of double taxation not provided for in the Convention. The Article also provides for the possibility of the use of arbitration to resolve disputes which cannot be settled by the competent authorities. The competent authorities of the two Contracting States are identified in subparagraph 1i) of Article 3 (General Definitions).

Paragraph 1 provides that where a resident of a Contracting State considers that the actions of one or both Contracting States will result for him in taxation which is not in accordance with the Convention he may present his case to the competent authority of his State of residence. A citizen of a Contracting State may bring a case under paragraph 1 of Article 24 (Nondiscrimination) to the competent authority of his State of citizenship. It is not necessary for a person first to have exhausted the remedies provided under the national laws of the Contracting States before presenting a case to the competent authorities. The paragraph provides that a case must be presented to the competent authorities no later than four years from the notification of the assessment which gives rise to the double taxation or taxation not in accordance with the provisions of the Convention. The four year period begins to run when the last formal notification of the assessment is issued. Thus, if the Internal Revenue Service makes a section 482 adjustment on a taxpayer's 1990 return, and, in 1994, sends the statutory notice of deficiency which results in double taxation, the taxpayer has until 1998 to present his case to the competent authority. When the case results from the combined action of the tax authorities in the two Contracting States, the four year time period begins to run when the formal notification of the second action is given. Although it is preferred U.S. policy to provide no time limit for the

presentation of a case to the competent authorities, the limit in paragraph 1 of the Convention should not result in any unreasonable denial of protection or assistance to taxpayers.

Paragraph 2 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 agreement with the competent authority of the other Contracting State such that taxation not in accordance with the Convention will be avoided. If agreement is reached under this provision, it is to be implemented even if implementation is otherwise barred by the statute of limitations or by some other procedural limitation, such as a closing agreement (but see explanation below of Paragraph 23 of the Protocol). Because, as specified in subparagraph (c) of paragraph I of the Protocol, 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 authorizes the competent authorities to seek 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. They may 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 principles of Article 7 (Business Profits) and Article 9 (Associated Enterprises). The competent authorities may also agree, under subparagraph (c), to settle a variety of conflicting applications of the Convention, including those regarding the characterization of items of income or of persons, the application of source rules to particular items of income and the treatment of income that is regarded as a dividend in one Contracting State and as a different class of income in the other. The competent authorities may agree to a common meaning of a term (subparagraph (d)) and 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 (subparagraph (e)). Agreements reached by the competent authorities under this paragraph need not conform to the internal law provisions of either Contracting State.

Subparagraph (f) of paragraph 3 authorizes the competent authorities to increase the dollar amounts referred to in Articles 17 (Artistes and Athletes) and 20 (Visiting Professors and Teachers; Students and Trainees) of the Convention to reflect economic and monetary developments. 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 for entertainers or the $5,000 earned income exemption threshold for students or trainees unrealistically low in terms of the original objectives in setting the thresholds, 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 provision can be applied only to the benefit of taxpayers, i.e., only to increase thresholds, not to reduce them.

Finally, paragraph 3 authorizes the competent authorities to consult for the purpose of eliminating double taxation in cases not provided for in the Convention, but with respect to the taxes covered by the Convention. 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 Germany. Since no resident of a Contracting State is involved in the case, the Convention does not, by its terms, apply, but the competent authorities may, nevertheless, use the authority of the Convention to seek to prevent the double taxation.

Paragraph 4 provides that the competent authorities may communicate with each other, including, where appropriate, in face-to-face meetings of representatives of the competent authorities, for the purpose of reaching agreement under this Article. The paragraph goes beyond the U.S. and OECD Models, and, to some extent, beyond current practice, by entitling the persons concerned in a particular competent authority case to present their views to the competent authorities of either or both Contracting States. The U.S. competent authority does receive and consider comments from U.S. taxpayers involved in a particular case. While it may also accept and consider comments from German taxpayers, it would not, absent this language, be obligated to do so.

Paragraph 5 introduces an arbitration procedure not found in other U.S. tax treaties. It provides that where the competent authorities have been unable to resolve a disagreement regarding the application or interpretation of the Convention, the disagreement may, by mutual consent of the competent authorities, be submitted for arbitration. Nothing in the provision requires that any case be submitted for arbitration. Paragraph 24 of the Protocol provides that if a case is submitted to an arbitration board, the board's decision in that case will be binding on both Contracting States with respect to that case. The exchange of notes, described below, specifies that the decision is also binding upon the taxpayer.

The arbitration procedures are to be agreed [upon] by the two Contracting States, and established by exchanges of notes through diplomatic channels. Notes were exchanged at the time of the signing of the Convention which specify a set of procedures to be used in the implementation of paragraph 5. Changes in these procedures may be made through future exchanges of diplomatic notes. The agreed procedures are as follows:

1.The competent authorities may agree to invoke arbitration in a specific case only after fully exhausting the procedures available under paragraphs 1 to 4 of Article 25, and if the taxpayer(s) consent to the arbitration and agree in writing to be bound by the arbitration decision. The competent authorities will not generally accede to arbitration with respect to matters concerning the tax policy or domestic tax law of either Contracting State.

2.The competent authorities shall establish an arbitration board for each specific case in the following manner:

(a) An arbitration board shall consist of not less than three members. Each competent authority shall appoint the same number of members, and these members shall agree on the appointment of the other member(s).

(b) The other member(s) of the arbitration board shall be from either Contracting State or from another OECD member country. The competent authorities may issue further instructions regarding the criteria for selecting the other member(s) of the arbitration board.

(c) Arbitration board members (and their staffs) upon their appointment must agree in writing to abide by and be subject to the applicable confidentiality and disclosure provisions of both Contracting States and the Convention. In case those provisions conflict, the most restrictive condition will apply.

3.The competent authorities may agree on and instruct the arbitration board regarding specific rules of procedure, such as appointment of a chairman, procedures for reaching a decision, establishment of time limits, etc. Otherwise, the arbitration board shall establish its own rules of procedure consistent with generally accepted principles of equity.

4.Taxpayers and/or their representatives shall be afforded the opportunity to present their views to the arbitration board.

5.The arbitration board shall decide each specific case on the basis of the Convention, giving due consideration to the domestic laws of the Contracting States and the principles of international law. The arbitration board will provide to the competent authorities an explanation of its decision. The decision of the arbitration board in a particular case shall be binding on both Contracting States and the taxpayer(s) with respect to that case. While the decision of the arbitration board shall not have precedential effect, it is expected that such decisions ordinarily will be taken into account in subsequent competent authority cases involving the same taxpayer(s), the same issue(s), and substantially similar facts, and may also be taken into account in other cases where appropriate.

6.Costs for the arbitration procedure will be borne in the following manner:

(a) each Contracting State shall bear the cost of remuneration for the member(s) appointed by it, as well as for its representation in the proceedings before the arbitration board;

(b) the cost of remuneration for the other member(s) and all other costs of the arbitration board shall be shared equally between the Contracting States; and

(c) the arbitration board may decide on a different allocation of costs.

However, if it deems appropriate in a specific case, in view of the nature of the case and the roles of the parties, the Competent Authority of a Contracting State may require the taxpayer(s) to agree to bear that Contracting State's share of the costs as a prerequisite for arbitration.

7.The competent authorities may agree to modify or supplement these procedures; however, they shall continue to be bound by the general principles established in the exchange of notes.

This Article is not subject to the saving clause of subparagraph (a) of Paragraph 1 of the Protocol. Thus, rules, definitions, procedures, etc., which 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.

Paragraph 23 of the Protocol relates to Article 25. It provides that if a taxpayer in a Contracting State has, in reaching an agreement with the tax authorities of that State, waived his right to appeal to the competent authorities tinder Article 25, nothing in the Article will be construed as requiring that State to disregard such waiver. Thus, if a taxpayer has agreed with the tax authority of his Contracting State to waive his rights in a particular matter, and the competent authority of the other Contracting State seeks competent authority agreement in that matter, the competent authority of the first-mentioned Contracting State is not obligated to consider the case.

ARTICLE 26
Exchange of Information and Administrative Assistance

This Article provides for the exchange of information between the competent authorities of the Contracting States. The information to be exchanged is that necessary for carrying out the provisions of the Convention or the domestic laws of the United States or Germany concerning the taxes covered by the Convention. The taxes covered by the Convention are those referred to in Article 2 (Taxes Covered). This differs from the U.S. Model, which, for purposes of exchange of information, covers all taxes imposed by the two Contracting States. However, paragraph 6 of this Article provides that the Contracting States may agree through the exchange of diplomatic notes to broaden the coverage of this Article by exchanging information for the purpose of taxes imposed by a Contracting State which are not identified as covered taxes by Article 2. 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.

Paragraph 1 states that information exchange is not restricted by Article 1 (General Scope). This means that 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 Germany 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 Germany, 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 Germany 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, concerned 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. The information must be used by these persons in connection with these designated functions. Persons concerned with the administration of taxes, in the United States, include legislative bodies, such as the tax-writing committees of Congress and the General Accounting office. Information received by these bodies is 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 unless the State supplying the information objects to such use. It is United States policy not to object to such use. As a general matter, it is not anticipated that Germany will raise objections to such use of information.

Paragraph 25 of the Protocol relates to the disclosure provisions of Article 26 and to the arbitration provisions of paragraph 5 of Article 25 (Mutual Agreement Procedure). The Protocol

provides that, when a case is referred to an arbitration board, confidential information necessary for carrying out the arbitration procedure may be released by the Contracting States to the board. The members of the board, and any staff, however, are subject to the disclosure rules of Article 26.

It is contemplated that the Contracting States will utilize Article 26 to exchange information on a routine basis, on request in relation to a specific case, or spontaneously. Paragraph 26 of the Protocol provides that Germany will exchange information with or without request to the extent provided for in its law of 19 December, 1985, as it may be amended from time to time without changing the law's general principle, i.e., that Germany will exchange information.

Paragraph 2 explains that the obligations undertaken in paragraph 1 to exchange information do not require a Contracting State to carry out administrative measures which are at variance with the laws or administrative practice of either State. Nor does that paragraph require a Contracting State 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. Either Contracting State may, however, at its discretion, subject to the limitations of the paragraph and its internal law, provide information which it is not obligated to provide under the provisions of this paragraph.

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. The paragraph 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 can be 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 and 5 provide 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. Paragraph 5 makes clear that the Contracting State asked to collect the tax is not obligated, in the process, 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.

ARTICLE 27
Exempt Organizations

Article 27 is essentially the same as Article XV A of the 1954 Convention. The Article

provides that a company or organization in one Contracting State which is operated exclusively for religious, charitable, scientific, educational or public purposes will be exempt from tax in the other Contracting State in respect of items of income if two conditions are met. The two conditions are

(1) that the company or organization be exempt from tax in its State of residence, and

(2) that the company or organization would be exempt from tax on such items of income in the other Contracting State, under its laws, if the company or organization were organized in that other State and carried on all of its activities there.

None of the benefits of this Article can be denied by the application of the provisions of Article 28 (Limitation on Benefits). Paragraph 27 of the Protocol provides that the competent authorities will develop procedures to implement the Article.

ARTICLE 28
Limitation on Benefits

Article 28 assures that source basis tax benefits granted by a Contracting State pursuant to the Convention are limited to the intended beneficiaries-residents of the other Contracting State -and are not extended to residents of third States not having a substantial business in, or business nexus with, the other Contracting State. For example, a resident of a third State might establish an entity resident in a Contracting State for the purpose of deriving income from the other Contracting State and claiming source State benefits with respect to that income. Absent Article 28, the entity would generally be entitled to benefits as a resident of a Contracting State, subject, however, to such limitations (e.g., business purpose, substance-over-form, step transaction or conduit principles) as may be applicable to the transaction or arrangement under the domestic law of the source State.

The structure of the Article is as follows: Paragraph 1 lists a series of attributes of a resident of a Contracting State, the presence of any one of which will entitle that person to benefits of the Convention in the other Contracting State. Several of these, which will be discussed first, are purely objective tests. One, in subparagraph (c), is more subjective, and requires some elaboration and interpretation. Paragraph 2 provides that benefits may be granted even to a person not entitled to benefits under the tests of paragraph 1, if the competent authority of the source State so determines. Paragraph 3 defines the term "recognized stock exchange" as used in paragraph 1. Paragraph 4 authorizes the competent authorities to develop agreed applications of the Article and to exchange information necessary for carrying out the provisions of the Article.

A memorandum of understanding was developed by the negotiators indicating how the provisions of the Article are to be understood both by the competent authorities and by taxpayers in the Contracting States. It is anticipated that as the competent authorities and taxpayers gain more experience with the concepts in this Article, some of which are relatively new, further guidance will be developed and made public.

Two categories of persons eligible for benefits from the other Contracting State under

subparagraphs (a) and (b) of paragraph 1 are

(1) individual residents of a Contracting State and

(2) the Contracting States, political subdivisions or local authorities thereof.

It is most unlikely that persons falling into these two categories can be used to derive treaty-benefited income, as the beneficial owner of the income, on behalf of a third-country person. If an individual is receiving income as a nominee on behalf of a third-country resident, benefits will be denied with respect to those items of income under the articles of the Convention which grant the benefit, because of the requirements in those articles that the beneficial owner of the income be a resident of a Contracting State.

Under subparagraph (d) a corporation which is a resident of a Contracting State is entitled to treaty benefits from the other Contracting State if there is substantial and regular trading in the corporation's principal class of shares on a recognized stock exchange. The term "recognized stock exchange" is defined in paragraph 3 of the Article to mean, in the United States, the NASDAQ System and any stock exchange which is registered as a national securities exchange with the Securities and Exchange Commission, and, in Germany, any German stock exchange on which registered dealings in shares take place. Paragraph 3 also provides that the competent authorities may, by mutual agreement, recognize additional exchanges for purposes of subparagraph 1(d).

Subparagraph (e) of paragraph 1 provides a two-part test, the so-called ownership and base erosion tests, both of which must be met for entitlement to benefits under this subparagraph. under these tests, benefits will be granted to a resident of a Contracting State other than an individual, if both

(1) more than 50 percent of the beneficial interest in the person (or, in the case of a corporation, more than 50 percent of each class of its shares) is owned, directly or indirectly, by persons who are themselves entitled to benefits under the other tests of paragraph 1 (other than subparagraph (c)), or by U.S. citizens, and

(2) more than 50 percent of the person's gross income is not used, directly or indirectly, to make deductible payments to persons, other than persons who are themselves eligible for benefits under the other tests of paragraph 1 (other than subparagraph (c)), or to U.S. citizens.

It is understood that the term "gross income" is to be interpreted as in U.S. law. Thus, in general, the term should be understood to mean gross receipts less cost of goods sold.

The rationale for this two-part test is that since treaty benefits can be indirectly enjoyed not only by equity holders of an entity, but also by that entity's various classes of obligees, such as lenders, licensors, service providers, insurers and reinsurers, and others, it is not enough, in order to prevent such benefits from inuring substantially to third-country residents, merely to require substantial ownership of the entity by treaty country residents or their equivalent. It is also necessary to require that the entity's deductible payments be made in substantial part to such treaty country residents or their equivalents. For example, a third-country resident could lend funds to a German-owned German corporation to be reloaned to the United States. The U.S. source interest income of the German corporation would be exempt from U.S. withholding tax under Article 11 (Interest) of the Convention. While the German corporation would be subject to

German corporation income tax, its taxable income could be reduced to near zero by the deductible interest paid to the third-country resident. If, under a Convention between Germany and the third country, that interest is exempt from German tax, the U.S. treaty benefit with respect to the U.S. source interest income will have flowed to the third-country resident.

Subparagraph (f) provides that a not-for-profit organization which is a resident of a Contracting State is entitled to benefits from the other Contracting State if it satisfies two conditions:

(1) It must be generally exempt from tax in its State of residence by virtue of its not-for-profit status, and

(2) more than half of the beneficiaries, members or participants, if any, in the organization must be persons entitled, under this Article, to the benefits of the Convention.

Paragraph 28 of the protocol clarifies that the not-for-profit organizations dealt within subparagraph l(f) include pension funds, pension trusts, private foundations, trade unions, trade associations and similar organizations. A pension fund or trust or similar entity created for the purpose of providing retirement, disability or other employment benefits is entitled to the benefits of the Convention if the organization sponsoring the fund, trust or entity is entitled to the Convention's benefits under Article 28. Thus, one need not determine that more than half of the beneficiaries of a German pension plan are residents of Germany in deciding whether the plan is entitled to U.S. treaty benefits in respect of its income so long as the German corporation sponsoring the fund is entitled to benefits under Article 28, because, for example, it is publicly traded on the Frankfurt stock exchange. If, however, the sponsoring organization is not entitled to benefits, the tests of subparagraph 10 must be met. Under the provision of Article 27 (Exempt Organizations), a not- for-profit organization, otherwise dealt within subparagraph 1(f) of Article 28, which is operated exclusively for religious, charitable, scientific, educational or other public purposes, is eligible for the source exemption provided by Article 27, notwithstanding any provisions of Article 28. Thus, a German charitable organization receiving dividend income from the United States is exempt from U.S. withholding tax under Article 27, even if all of the beneficiaries of the charity are residents of a third country.

Subparagraph 1(c) of Article 28 provides a test for eligibility for benefits which looks not solely at objective characteristics of the person deriving the income, but at the nature of the activity engaged in by that person and the connection between the income and that activity. Under the subparagraph, a resident of a Contracting State deriving income from the other Contracting State is entitled to benefits if the person Is engaged in an active trade or business in his State of residence, and the item of income in question is derived in connection with, or is incidental to, that trade or business. Income which is derived in connection with, or is incidental to, the business of making or managing investments will not qualify for benefits under this provision, unless the business is a bank or insurance company engaged in banking or insurance activities.

In general, it is expected that if a person qualifies for benefits under the other subparagraphs of paragraph 1, no inquiry will be made into qualification for benefits tinder subparagraph l(c). Upon satisfaction of any of the other tests of paragraph 1, any income derived by the beneficial owner from the other Contracting State is entitled to treaty benefits. Under

subparagraph 1(c), however, the test is applied separately for each item of income.

It is intended that the provisions of subparagraph 1(c) will be self-executing. Unlike the provisions of paragraph 2, discussed below, claiming benefits under this subparagraph 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 subparagraph and is not entitled to the benefits claimed.

A memorandum was exchanged at the time of the signing of the Convention which suggests, by means of examples, the understandings reached by the negotiators as to the intended scope of subparagraph 1(c). The examples, structured for purposes of exposition in terms of a German entity claiming U.S. treaty benefits, are reproduced in the following paragraphs. They are not intended to be exhaustive, but are merely illustrative of the kinds of considerations which are relevant in making a determination as to whether a particular case falls within the scope of the subparagraph 1(c).

Example I

Facts: A German resident company is owned by three persons, each resident in a different third country. The company is engaged in an active manufacturing business in Germany. It has a wholly-owned subsidiary in the United States which has been capitalized with debt and equity. The subsidiary is engaged in selling the output of the German parent. The active manufacturing business in Germany is substantial in relation to the activities of the U.S. subsidiary. Are the subsidiary's interest and dividend payments to its German parent eligible for treaty benefits in the United States?

Analysis: Treaty benefits would be allowed because the treaty requirement that the U.S. income is "derived in connection with or is incidental to" the German active business is satisfied. This conclusion is based on two elements in the fact pattern presented:

(1) the income is connected with the active German business in this example in the form of a "downstream" connection; and

(2) the active German business is substantial in relation to the business of the U.S. subsidiary.

Example II

Facts: The facts are the same as Example I except that while the income is derived by the German parent of the U.S. subsidiary, the relevant business activity in Germany is carried on by a German subsidiary corporation. The German subsidiary's activities meet the business relationship and substantiality tests of the business connection provision, as described in the preceding example. Are the U.S. subsidiary's dividends and interest payments to the German parent eligible for U.S. treaty benefits?

Analysis: Benefits are allowed because the two German entities (i.e., the one deriving the income and the one carrying on the substantial active business in Germany) are related. Benefits are not denied merely because the income is earned by a German holding company and the relevant activity is carried on in Germany by a German subsidiary. The existence of a similar holding company structure in the United States would not affect the right of the German parent to treaty benefits. Thus, if the German parent owns a subsidiary in the United States which is, itself, a holding company for the group's U.S. activities, which are related to the business activity in Germany, dividends paid by the U.S. holding company to the German parent holding company would be tested for eligibility for benefits in the same way as described above, ignoring the fact that the activities are carried on by one entity and the income in respect of which benefits are claimed is paid by another, related, entity.

Example III

Facts: A German resident company is owned by three persons, each resident in a different third country. The company is the worldwide headquarters and parent of an integrated international business carried on through subsidiaries in many countries. The company's wholly-owned U.S. and German subsidiaries manufacture, in their countries of residence, products which are part of the group's product line. The United States subsidiary has been capitalized with debt and equity. The active manufacturing business of the German subsidiary is substantial in relation to the activities of the U.S. subsidiary. The German parent manages the worldwide group and also performs research and development to improve the manufacture of the group's product line. Are the U.S. subsidiary's dividend and interest payments to its German parent eligible for treaty benefits in the United States?

Analysis: Treaty benefits would be allowed because the treaty requirement that the United States income is "derived in connection with or is incidental to" the German active business is satisfied. This conclusion is based on two elements in the fact pattern presented:

(1) the income is connected with the German active business because the United States subsidiary and the German subsidiary manufacture products which are part of the group's product line, the German parent manages the worldwide group, and the parent performs research and development that benefits both subsidiaries; and

(2) the active German business is substantial in relation to the business of the U.S. subsidiary.

Example IV

Facts: A third-country resident establishes a German corporation for the purpose of acquiring a large U.S. manufacturing company. The sole business activity of the German corporation (other than holding the stock of the U.S. corporation) is the

operation of a small retailing outlet which sells products manufactured by the U.S. company. Is the German corporation entitled to treaty benefits under subparagraph 1(c) with respect to dividends it receives from the U.S. manufacturer?

Analysis: The dividends would not be entitled to benefits. Although there is, arguably, a business connection between the U.S. and the German businesses, the "substantiality" test described in the preceding examples is not met.

Example V

Facts: German, French and Belgian corporations create a joint venture in the form of a partnership organized in Germany to manufacture a product in a developing country. The joint venture owns a U.S. sales corporation, which pays dividends to the joint venture. Are these dividends eligible for U.S.-German treaty benefits?

Analysis: Under Article 4, only the German partner is a resident of Germany for purposes of the treaty. The question arises under this treaty, therefore, only with respect to the German partner's share of the dividends. If the German partner meets the ownership and base erosion or the public trading tests of subparagraph 1(d) or (e), it is entitled to benefits without reference to subparagraph 1(c). If not, the analysis of the previous examples would be applied to determine eligibility for benefits under 1(c). The determination of treaty benefits available to the French and Belgian partners will be made under the United States treaties with France and Belgium.

Example VI

Facts: A German corporation, a French corporation and a Belgian corporation create a joint venture in the form of a German resident corporation in which they take equal shareholdings. The joint venture corporation engages in an active manufacturing business in Germany. Income derived from that business that is retained as working capital is invested in U.S. Government securities and other U.S. debt instruments until needed for use in the business. Is interest paid on these instruments eligible for U.S.- German treaty benefits?

Analysis: The interest would be eligible for treaty benefits. Interest income earned from short-term investment of working capital is incidental to the business in Germany of the German joint venture corporation.

Paragraph 2 of Article 28 provides that a resident of a Contracting State that derives income from the other Contracting State and is not entitled to the benefits of the Convention under any of the provisions of paragraph 1, may, nevertheless, be granted benefits at the discretion of the competent authority of the Contracting State in which the income arises.

The paragraph itself provides no guidance to competent authorities or taxpayers as to

how the discretionary authority is to be exercised. The memorandum of understanding does provide some discussion and guidance. Relevant portions of that memorandum are reproduced in the discussion which follows.

It is assumed that, for purposes of implementing paragraph 2, a taxpayer will be permitted to present his case to his competent authority for an advance determination based on the facts, and will not be required to wait until the tax authorities of one of the Contracting States have determined that benefits are denied. 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.

In making determinations under paragraph 2, it is understood that the competent authorities will take into account all relevant facts and circumstances. The factual criteria which the competent authorities are expected to take into account include the existence of a clear business purpose for the structure and location of the income earning entity in question; the conduct of an active trade or business (as opposed to a mere investment activity) by such entity; and a valid business nexus between that entity and the activity giving rise to the income. The competent authorities will, furthermore, consider, for example, whether and to what extent a substantial headquarters operation conducted in a Contracting State by employees of a resident of that State contributes to such valid business nexus, and should not, therefore, be treated merely as the "making or managing [of] investments" within the meaning of subparagraph 1(c) of Article 28.

The discretionary authority granted to the competent authorities in paragraph 2 is thought to be particularly important in view of the developments in, and objectives of, international economic integration, such as that among the member countries of the European Communities and between the United States and Canada. It is expected that the authority will be exercised with particular cognizance of those factors.

The following example illustrates the application of these principles:

Facts: German, French and Belgian companies, each of which is engaged directly or through its affiliates in substantial active business operations in its country of residence, decide to cooperate in the development, production and marketing of an advanced passenger aircraft through a corporate joint venture with its statutory seat in Germany. The development, production and marketing aspects of the project are carried out by the individual joint ventures. The joint venture company, which is staffed with a significant number of managerial and financial personnel seconded by the joint ventures, acts as the general headquarters for the joint venture, responsible for the overall management of the project including coordination of the functions separately performed by the individual joint ventures on behalf of the joint venture company, the investment of working capital contributed by the joint ventures and the financing of the project's additional capital requirements through public and private borrowings. The joint venture company derives portfolio investment income from U.S. sources. Is this

income eligible for benefits under the U.S.-German treaty?

Analysis: If the joint venture corporations' activities constitute an active business and the income is connected to that business, benefits would be allowed under subparagraph 1(c). If not, it is expected that the U.S. competent authority would determine that treaty benefits should be allowed in accordance with paragraph (2) under the facts presented, particularly in view of

(1) the clear business purpose for the formation and location of the joint venture company;

(2) the significant headquarters functions performed by that company in addition to financial functions; and

(3) the fact that all of the joint ventures are corporations resident in EEC member countries in which they are engaged directly or through their affiliates in substantial active business operations.

ARTICLE 29
Refund of Withholding Tax

This Article establishes rules for the implementation by a Contracting State of reduced withholding at source, as provided in the Convention, on items of income, such as dividends, interest and royalties, derived by a resident of the other Contracting State. Paragraphs 1 through 4 of the Article provide for the imposition of tax at statutory rates and the payment of refunds, upon application, to the extent necessary to reduce the tax payment to the level prescribed in the Convention. Application for refund of tax with respect to an item of income must be made within four years from the end of the calendar year in which the item of income is received. The Contracting State in which the income arises may require certification by the State of residence of the income recipient that the recipient has fulfilled any applicable conditions for unlimited tax liability in that State.

The procedures described above will be implemented by competent authority agreement pursuant to Article 25 (Mutual Agreement Procedure). The competent authorities may also establish by mutual agreement other procedures for the implementation of tax benefits provided for in the Convention.

This Article was included at the request of Germany. The U.S. Model does not spell out procedures for the implementation of reduced withholding at source. Such procedures, however, including the types of requirements and conditions provided for in Article 29 are considered by the United States to be implicitly authorized by treaties. The United States does not presently intend, on the basis of this Article, to modify its current procedures with respect to U.S. withholding of tax on income payments to residents of Germany. Any changes which may be made in U.S. procedures will be generally applicable under U.S. treaties.

ARTICLE 30
Members of Diplomatic Missions and Consular Posts

Paragraph 1 provides that any fiscal privileges to which diplomatic or consular officials are entitled under general provisions of international law or under special agreements will apply notwithstanding any provisions to the contrary in the Convention. If, however, because of such privileges, income or capital is not taxed in the receiving State, paragraph 2 grants to the sending State the right to tax the income or capital.

Under paragraph 3, an individual who is a member of a diplomatic mission or consular post of a Contracting State, whether situated in the other Contracting State or in a third State, will be deemed to be a resident of the sending State if two conditions are met:

(1) in accordance with international law, the individual is not subject to tax in the receiving State in respect of income from sources outside that State or in respect of capital situated outside that State, and

(2) the individual is liable to tax in the sending State on worldwide income and capital in the same manner as residents of that State.

Residence as determined under this paragraph will apply notwithstanding any result to the contrary from the application to such individual of the rules of Article 4 (Residence).

The saving clause of subparagraph (a) of Paragraph I of the Protocol 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 there.

Paragraph 4 clarifies that the Convention does not apply to international organizations or to organs or officials of such organizations, or to members of diplomatic missions or consular posts of third States present in a Contracting State if such persons are not liable to the income or capital tax obligations of residents in either Contracting State.

ARTICLE 31
Berlin Clause

Article 31 provides that the Convention will apply in Land Berlin (i.e., Berlin (West)) so long as the German Government has not notified the Government of the United States to the contrary within three months of the date of entry into force of the Convention. Similar rules applied under the 1954 Convention and the 1965 Protocol thereto.

ARTICLE 32
Entry into Force

This Article provides the rules for bringing the Convention into force and giving effect to its provisions. Paragraph 1 provides for the ratification of the Convention by both Contracting States and the prompt exchange of instruments of ratification at Washington.

Paragraph 2 provides that the Convention will enter into force on the date on which

instruments of ratification are exchanged. It further provides the general rules for the effective dates of the provisions of the Convention. Paragraphs 3 through 6 provide exceptions to these general effective date rules for particular classes of income. Under subparagraph 2(a) the Convention will have effect with respect to taxes withheld at source on dividends, interest and royalties, and to excise taxes imposed on insurance premiums, for amounts paid or credited on or after January 1, 1990. For all other income taxes, the Convention will have effect for any taxable year or assessment period beginning on or after January 1, 1990. This does not include income for any fiscal year beginning before January 1, 1990. This latter exception is necessary to assure that the Convention does not apply to a German assessment period which begins after January 1, 1990, but which includes income from a fiscal year which began prior to that date. With respect to taxes on capital, the Convention will have effect for taxes levied on items of capital owned on or after January 1, 1990.

Paragraph 3 provides a general exception to the effective date rules of paragraph 2. Under this paragraph, if the 1954 Convention would have afforded greater relief from tax to a person entitled to its benefits than would be the case under this Convention, that person may elect to remain subject to all of the provisions of the 1954 Convention for the first assessment period or taxable year with respect to which this Convention would have had effect under the provisions of paragraph 2(b) of this Article. Where, however, a provision has an effective date which is delayed beyond that provided in paragraph 2, under the provisions of paragraph 4, 5 or 6, the general exception in paragraph 3 does not apply. Under the general rule, for example, a resident performing independent personal services in Germany through a German fixed base for 30 days in 1990 would be subject to German tax under Article 14 (Independent Personal Services) of the Convention. Under Article X of the 1954 Convention, however, he would not be subject to German tax if he is under contract to a person who is not a German resident. Under paragraph 3 of Article 32, that individual may elect to be subject to the 1954 Convention for one additional year. If he makes such an election, he will not be subject to German tax on his personal services income. However, if, for example, he also derives portfolio dividend income from Germany which would be entitled to additional relief under the provisions of paragraph 3 of Article 10 (Dividends) of the Convention with respect to dividends paid after January 1, 1990, the election would postpone the effect of that benefit for one additional year as well.

An example of the exception to the general one-year grace period rule might involve the branch tax. The 1954 Convention has been interpreted as preventing the United States, subject to certain statutory limitations, from imposing the branch tax on income attributable to a U.S. permanent establishment of a German enterprise. This Convention permits the application of the branch tax, but its effective date is delayed one year under the provisions of paragraph 5 to assessment periods or taxable years beginning on or after January 1, 1991. A German enterprise with a permanent establishment in the United States may not elect to retain the benefits of the 1954 Convention for one additional year, and thus prevent application of the branch tax until 1992, because the effective date of the branch tax is provided under a special rule of subparagraph 5(a) rather than under the general rule of paragraph 2.

Paragraph 4 provides a special effective date rule for direct investment dividends which arc subject to the provisions of subparagraph 2(a) of Article 10 (Dividends). That subparagraph provides that the rate of tax at source on such dividends may not exceed 5 percent. Paragraph 4

provides that the maximum rate of 5 percent will apply to dividends distributed on or after January 1, 1992. Direct investment dividends paid or credited on or after January 1, 1990 but before January 1, 1992 will be subject to tax at source at a maximum rate of 10 percent. This rate applies regardless of whether the taxpayer has elected to claim the benefits of the grace period provided in paragraph 3.

Subparagraph 5(a) provides the effective date for the application of the branch tax under paragraph 8 of Article 10 (Dividends). Subparagraph 5(a) provides that the branch tax may first be imposed in respect of dividend equivalent amounts for assessment periods or taxable years beginning on or after January 1, 1991, but excluding fiscal years beginning before that date. For this purpose, the dividend equivalent amount is treated as paid on the last clay of the company's fiscal year. The rate of the tax will be 5 percent from the time the tax may first be imposed, in 1991, even though the rate of withholding at source on direct investment dividends will be 10 percent through December 31, 1991.

Subparagraph 5(b) deals with the effective dates for the rules for relief from double taxation in Germany with respect to dividends paid by U.S. Regulated Investment Companies ("RICs"). Paragraph 2(a) of Article' 23 (Relief from Double Taxation) provides that the exemption otherwise allowable from German tax with respect to direct investment dividends will not apply to dividends paid by RICs and to other distributions which have been deducted by the company making the distribution in calculating its U.S. income tax. Subparagraph 5(b) of Article 32 delays that exemption denial to RIC dividends paid on or after January 1, 1991, by RICs which were in existence on October 1, 1988. Thus, dividends paid prior to January 1, 1991 by a RIC which existed on October 1, 1988 to a German company which owns at least 10 percent of the voting shares of the RIC will be exempt from German tax, provided that the dividend is taxable in the United States. U.S. tax on such RIC dividends paid after December 31, 1990 will be subject to a foreign tax credit in Germany.

Paragraph 6 provides special rules for items of income described in Article 11 (Interest) and in paragraphs 4 and 5 of Article 10 (Dividends). Which of these rules applies generally depends upon the treatment by the Contracting States of certain payments carrying the right to participate in profits of the payor. If a Contracting State denies deductibility of such payments by the payor, then such payments are subject to one set of rules. If a Contracting State does not deny deductibility, such payments are subject to a second set of rules. In addition, the treatment provided by the 1954 Convention is extended for a limited period with respect to certain payments.

Paragraph 6(a) provides that the 1954 Convention and not this Convention shall apply to interest, as that term is used in the 1954 Convention, that is paid or credited before January 1, 1991. Thus, interest payments made with respect to debt instruments carrying the right to participate in profits that are treated as interest for purposes of the 1954 Convention and otherwise meet the requirements of that Convention will continue to be exempt from source country taxation until 1991. Beginning in 1991, payments made with respect to such hybrid debt instruments (including, in the case of the United States "equity kicker" loans) will depend on the treatment of such payments under the national law of the Contracting States. Under current law, such payments would generally be subject to a 25 percent withholding tax when paid by a

resident of Germany and a 30 percent withholding tax when paid by a resident of the United States (unless treated as portfolio interest).

Paragraph 6(b) provides that income from debt obligations to which paragraph 4 of Article 10 (Dividends) applies (i.e., income that is subjected to the same taxation treatment as income from shares by the source state), as well as in the case of the German income from a partiarisehes Darlehen or a Gewinnobligation to which paragraph 5 of Article 10 does not apply (i.e., income that, in the event of a change in German law, is no longer deductible in determining the profits of the payor) that is paid or credited after January 1, 1991 shall be taxable in the source country at the rates provided for in paragraphs 2 and 3 of Article 10. Thus, if Germany or the United States amends its law to deny the deductibility of payments made with respect to hybrid debt instruments in order to assimilate such payments to dividends, payments treated as dividends under national law could be entitled to the 5 percent withholding rate on direct dividends as early as 1991, provided such payments otherwise meet the conditions of Article 10.

Paragraph 6(c) provides that in the case of Germany income derived under a Stille Gesellsehaft and income derived from jouissance shares or rights to which paragraph 5 of Article 10 applies (i.e., income that remains deductible under German law in determining the profits of the payor) that is paid or credited before January 1, 1991 shall not be taxable in Germany at a rate exceeding 15 percent. Thus, if the Federal Republic of Germany does not amend its law to deny deductibility of payments made with respect to a Stille Gesellschaft or jouissance shares or rights, payments made with respect to such rights will remain subject to the 15 percent dividend rate of the 1954 Convention until 1991. Thereafter, paragraph 5 of Article 10 permits Germany to apply its national law to such payments. Under current German law such payments would generally be subject to a withholding tax of 25 percent.

Paragraph 6(d) provides that in the case of Germany income derived under a Stille Gesellschaft and income derived from jouissance shares or rights to which paragraph 5 of Article 10 does not apply (i.e., income that, in the event of a change in German law, is no longer deductible in determining the profits of the payor) that is paid or credited on or after January 1, 1990 shall be taxable in Germany at the rates provided for in paragraphs 2 and 3 of Article 10. Thus, if Germany amends its law to deny the deductibility of payments made with respect to a Stille Gesellschaft or jouissance shares or rights, such payments could be entitled to the 5 percent withholding rate on direct dividends as early as 1990, provided such payments otherwise meet the conditions of Article 10.

Paragraph 6(e) makes clear that the special transition rules of paragraph 6 do not apply to dividends or interest attributable to a permanent establishment or fixed base situated in the source country.

The special effective date rules provided for in paragraphs 4, 5, and 6 of Article 32 are summarized in the following table indicating the level of source country taxation for different classes of income in each of the years 1989-1992:

Paragraph 7 provides that the 1954 Convention will cease to have effect at the time this Convention takes effect under the provisions of this Article. Thus, with respect to items of

income and taxes to which this Convention applies, the 1954 Convention will cease to have effect at the latest on January 1, 1992.

ARTICLE 33
Termination

The Convention is to remain in effect indefinitely, unless terminated by one of the Contracting States in accordance with the provisions of Article 33. The Convention may be terminated at any time after 5 years from the date of its entry into force, provided that at least six months' prior written notice has been given through diplomatic channels. Thus, if notice is given on or before June 30 of any calendar year after 1994, the termination will have effect as follows:

(1) with respect to taxes on income, the Convention will cease to have effect for taxable years or assessment periods beginning on or after January 1 of the calendar year following the year in which notice is given (but not including fiscal years beginning before that date);

(2) with respect to taxes on capital, the Convention will cease to have effect for items of capital existing on or after January 1 of the calendar year following that in which the notice of termination is given; and

(3) with respect to taxes withheld at source on dividends, interest, and royalties and to excise taxes imposed on insurance premiums, the Convention will cease to have effect for amounts paid or credited on or after January 1 of the calendar year following the year in which the notice is given.

Nothing in Article 33, which relates to unilateral termination by a Contracting State of the Convention, should be construed as preventing the Contracting States from entering into a new bilateral agreement that supersedes, amends or terminates provisions of the Convention either prior to the expiration of the five year period or without the six month notification period.