NEW ARTICLE 1 (GENERAL SCOPE) PARAGRAPH 7:

7. Where an enterprise of a Contracting State derives income from the other Contracting State, and the first-mentioned Contracting State treats that income as attributable to a permanent establishment situated outside of that Contracting State, the tax benefits that otherwise would apply under the other provisions of this Convention shall not apply to that income if:

   a) the profits of that permanent establishment are subject to a combined aggregate effective rate of tax in the first-mentioned Contracting State and the state in which the permanent establishment is situated of less than 60 percent of the general rate of company tax applicable in the first-mentioned Contracting State; or

   b) the permanent establishment is situated in a third state that does not have a comprehensive income tax treaty in force with the Contracting State from which the benefits of this Convention are being claimed, unless the first-mentioned Contracting State includes the income attributable to the permanent establishment in its tax base.

Any income to which the provisions of this paragraph apply shall be taxed in accordance with the domestic law of the other Contracting State, notwithstanding any other provision of this Convention. However, if a resident of a Contracting State is denied the benefits of this Convention pursuant to this paragraph, the competent authority of the other Contracting State may, nevertheless, grant the benefits of this Convention with respect to a specific item of income, if such grant of benefits is justified in light of the reasons such resident did not satisfy the requirements of this paragraph.

TECHNICAL EXPLANATION:

Paragraph 7 deals with the treatment of income in situations where a resident of a Contracting State earns income from the other Contracting State through a permanent establishment situated outside of the Contracting State of residence, and the resident is subject to a significantly lower tax rate with respect to the income attributable to the permanent establishment.

The following example illustrates the application of this paragraph:

A resident of the other Contracting State sets up a permanent establishment in a third state that imposes a low or zero rate of tax on the income of the permanent establishment. The income attributable to the permanent establishment is exempt from tax by the other Contracting State, either pursuant to an income tax treaty in force between the other Contracting State and the third state where the permanent establishment is located or pursuant to the other Contracting State’s domestic law. The resident of the other Contracting State lends funds into the United States through the permanent establishment. The permanent establishment, despite being situated in a third state, is an integral part of the resident of the other Contracting State. Therefore, interest received by the resident with respect to loans issued by the permanent
established, absent the provisions of paragraph 7, would be entitled to exemption from U.S. withholding tax under the Convention (assuming all other requirements in Article 11 (Interest) have been satisfied). Thus, the interest income, absent paragraph 7, would be exempt from U.S. tax, subject to little or no tax in the third state of the permanent establishment, and exempt from tax in the other Contracting State.

Paragraph 7 provides that when an enterprise of a Contracting State derives income from the other Contracting State that is treated as attributable to a permanent establishment situated outside the Contracting State of residence, the tax benefits that otherwise would apply under the other provisions of the Convention will not apply to that income if either of the following is true: (a) the profits of that permanent establishment are subject to a combined aggregate effective rate of tax in the first-mentioned Contracting State and the state in which the permanent establishment is situated of less than 60 percent of the general rate of company tax applicable in the first-mentioned Contracting State or (b) the state in which the permanent establishment is situated does not have a comprehensive income tax treaty in force with the Contracting State from which the benefits of the Convention are being claimed. Any income to which this paragraph applies will be subject to tax under the domestic law of the Contracting State from which benefits are being claimed, notwithstanding any other provision of this Convention.

Assume, for example, that a resident of the other Contracting State engages in an activity in the United States that does not rise to the level of a trade or business and is therefore not taxed by the United States. The other Contracting State treats such activity as a permanent establishment situated in the United States. U.S. source interest is paid to the resident of the other Contracting State, and the other Contracting State treats the interest as attributable to the U.S. permanent establishment. If the combined aggregate effective rate of tax on the profits treated as attributable to the permanent establishment, taking into account taxes paid both in the United States and the other Contracting State is less than 60 percent of the general rate of company tax applicable in the other Contracting State, the provisions of subparagraph 7(a) would be triggered. Thus, the U.S. source interest paid to the resident of the other Contracting State would be subject to tax in accordance with domestic law of the United States.

In general, the principles employed under Code section 954(b)(4) will be employed to determine whether the profits are subject to an effective rate of taxation that is above the specified threshold.

If a resident of a Contracting State is denied the benefits of this Convention pursuant to this paragraph, the competent authority of the other Contracting State may, nevertheless, grant the benefits of this Convention with respect to a specific item of income, if such grant of benefits is justified in light of the reasons such resident did not satisfy the requirements of this paragraph.

Paragraph 7 applies reciprocally. The United States, however, does not exempt the profits of a third-jurisdiction permanent establishment of a U.S. resident from U.S. tax, either by statute or by treaty.