TECHNICAL EXPLANATION OP THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE STATE OF ISRAEL WITH RESPECT TO TAXES ON INCOME, SIGNED AT WASHINGTON, D.C. ON NOVEMBER 20, 1975, AS AMENDED BY A PROTOCOL SIGNED AT WASHINGTON, D.C. ON MAY 30, 1980

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INTRODUCTION

This is a technical explanation of the Convention between the United States and Israel, signed on November 20, 1975, as amended by a Protocol signed on May 30, 1980, ("the Convention"). This explanation is an official guide to the Convention. It reflects policies behind particular Convention provisions, as well as understandings reached with respect to the interpretation and application of the Convention.

TABLE OF ARTICLES

ARTICLE 1
Taxes Covered

Paragraph (1) designates the taxes of the Contracting States which are the subject of the Convention. With respect to the United States, the subject taxes are the Federal income taxes imposed by the Internal Revenue Code ("Code"). The Convention also applies to the excise tax on insurance premiums paid to foreign insurers, under section 4371 of the Code. However, the excise tax on insurance premiums is covered only to the extent that the foreign insurer does not reinsure the risks, directly or indirectly, with a person who is not entitled to exemption from such tax under this or another United States tax convention. This limitation on coverage is intended to clarify that persons not entitled to the benefits of this or another convention may not use an insurer in Israel as a conduit for the purpose of obtaining convention benefits. Moreover, as provided by paragraph (5) of Article 6 (General Rules of Taxation). The United States reserves the right to impose taxes under Code sections 531 (accumulated earnings tax) and 541 (personal holding company tax), except as provided in such paragraph (5).

United States taxes not generally covered by the Convention include the estate, gift and generation skipping transfer taxes, the Windfall Profits Tax, Federal unemployment taxes and social security taxes imposed under sections 1401, 3101 and 3111 of the Code.

In the case of Israel, paragraph (1) provides that the Convention applies to the income tax (including capital gains tax); the company tax; the tax on gains from the sale of land under the land appreciation tax law; the tax on profits levied on banking institutions and insurance companies under the Value Added Tax Law; and compulsory loans made with respect to taxable years ending before April 1, 1988, with respect to corporations that became subject thereto before April 1, 1977. This reflects the fact that compulsory loans are being phased-out from Israeli law. See the discussion of Article 26 (Relief from Double Taxation) for an analysis of the treatment of these compulsory loans for purposes of the United States foreign tax credit.

Pursuant to paragraph (2), the Convention will also apply to taxes substantially similar to those covered by paragraph (1) which are imposed in addition to, or in place of, existing income taxes, after November 20, 1975 (the date of signature of the Convention).

Under paragraph (3), for purposes of Article 27 (Nondiscrimination), the Convention applies to taxes of every kind imposed at the national level.

Paragraph (4) provides that the competent authority of each Contracting State will notify the competent authority of the other Contracting State of any substantial amendment of the tax laws referred to in paragraph (1), or of the adoption of substantially similar taxes imposed in addition to, or in place of, those taxes by transmitting the texts of such amendments or statutes. Paragraph (5) provides for a similar exchange with respect to the publication of material concerning the application of the Convention, whether in the form of regulations, rulings or judicial decisions.

ARTICLE 2
General Definitions

Paragraph (1) sets out definitions of certain basic terms used in the Convention. Unless the context otherwise requires, the terms defined in this paragraph have a uniform meaning throughout the Convention. A number of important terms, however, are defined elsewhere in the Convention.

The term "United States" means the United States of America. When used in a geographical sense, the term means the states of the United States and the District of Columbia. Thus, the Convention does not apply to the possessions of the United States or the Commonwealth of Puerto Rico. The term "Israel" means the State of Israel.

When used in a geographical sense, the terms "United States" and "Israel" also include their respective territorial seas, and in general accord with the principles of section 638 of the Code, their respective continental shelves.

The term "Contracting State" is defined to mean the United States or Israel as the context requires. The term "State" means the United States, Israel, or any other national State.

The term "person" is defined as including an individual, a partnership, a corporation, an estate or a trust.

The term "United States corporation" is defined as a corporation, or any unincorporated entity which is treated as a corporation for United States tax purposes, which is created or organized under the laws of the United States, any state thereof, or the District of Columbia. An Israeli corporation is defined as any body of persons taxed as a body of persons resident in Israel under its income tax ordinance. Thus, for example, a corporation incorporated in a State other than a Contracting State which is taxed by Israel as a body of persons resident in Israel will be an Israeli corporation for purposes of the Convention. See, however, the discussion of paragraph (3) of Article 3 (Fiscal Residence) for the treatment of a corporation which is both resident of the United States and a resident of Israel.

With respect to the United States, the term "competent authority" means the Secretary of the Treasury or his delegate. With respect to Israel, it means the Minister of Finance or his delegate. The term "tax" means those taxes imposed by the United States or Israel to which the

Convention applies by virtue of Article 1 (Taxes Covered).

The term “international traffic” is defined as any voyage of a ship or aircraft operated by a resident of one of the Contracting States except where such voyage is confined solely to places within a Contracting State. Thus, for example, coastal shipping along the Atlantic coast of the United States is not a voyage in international traffic. However, if a ship operated by a resident of Israel transports goods from Canada to the United States, leaving some of the goods in New York and the remainder in Norfolk, the portion of the voyage between New York and Norfolk is international traffic.

Paragraph (2) provides that any term used in the Convention which is not defined therein shall, unless the context otherwise requires, have the meaning which it has under the laws of the Contracting State whose tax is being determined. However, where a term has a different meaning under the laws of Israel and the United States or where the meaning under the laws of one of the Contracting States is not readily determinable, the competent authorities may for purposes of the Convention establish a common meaning, which may differ from the meaning under the laws of either or both Contracting States, in order to prevent double taxation or to further any other purpose of the Convention.

ARTICLE 3
Fiscal Residence

This Article sets forth rules for determining the residence of individuals, corporations, and other persons for purposes of the Convention. Residence is important because, in general, only a resident of one of the Contracting States may qualify for the benefits of the Convention. A person who, under the respective taxation laws of the Contracting States, is a resident of one Contracting State and not the other need look no further to determine his residence under the Convention. However, where a person is a resident of each of the Contracting States under its laws, paragraphs (2) and (3) of the Article must be used to determine that person's residence for purposes of the Convention. The Convention definition is, of course, exclusively for purposes of the Convention.

Under paragraph (1), the term “resident of Israel” means an Israeli corporation (as defined in Article 2 (General Definitions)) or any other person (except a corporation or any entity treated under Israeli law as a corporation) resident in Israel for purposes of Israeli tax. Similarly, resident of the United States means a United States corporation (as defined in Article 2 (General Definitions)) and any other person (except a corporation or any entity treated as a corporation for United States tax purposes) resident in the United States for purposes of United States tax. Thus, a resident of the United States includes a resident alien individual, an alien present in the United States who elects to be treated as a resident under Code section 6013(g) or (h), and a resident citizen, but under no circumstances, a foreign corporation. A citizen of the United States or Israel is not automatically a resident of the United States or Israel for purposes of this Convention. Whether a citizen of the United States is a resident of the United States for this purpose is to be determined by the principles of the Treasury regulations issued under Code section 871.

The Convention provides that a partnership, estate, or trust is a resident of a Contracting State only to the extent that the income derived by such person is subject to tax in such Contracting State as the income of a resident. For example, under United States law, a partnership is never, and an estate or trust is often not, taxed as such. Under the Convention, in the case of the United States, income received by a partnership, estate, or trust will not qualify for the benefits of the Convention unless such income is subject to tax in the United States as the income of a resident. Thus, in effect, the treatment of income received by a partnership will be determined by the residence and taxation of its partners with respect to that income. To the extent the partners are subject to United States tax as residents of the United States, the partnership will be treated as a resident of the United States. Similarly, the treatment of income received by a trust or estate will be determined by the residence and taxation of the person subject to tax on such income, which may be the grantor, the beneficiaries or the trust or estate itself, as the case may be.

Under paragraph (2), an individual who is a resident of both Contracting States under paragraph (1) will be deemed to be a resident of the Contracting State in which he has his permanent home, his center of vital interests (closest personal and economic relations), a habitual abode, or his citizenship, in the order listed. In the case of an individual who is an “oleh” under section 9(16) of the Israeli Income Tax Ordinance, his center of vital interests will be deemed to be in Israel. If the issue is not settled by these tests, the competent authorities will decide by mutual agreement the one Contracting State of which he will be considered to be a resident.

Paragraph (3) provides that a corporation which qualifies both as a resident of the United States and as a resident of Israel under Article 2 (General Definitions) will be considered to be outside the scope of the Convention, except for purposes of paragraph (1) of Article 4 (Source of Income), Article 27 (Nondiscrimination), Article 29 (Exchange of Information), and Article 31 (Entry into Force). The rule is necessary because a corporation incorporated in the United States may be deemed under the Convention to be a resident of Israel if it is taxed by Israel as a body of persons resident in Israel because it is managed and controlled in Israel. As a resident of Israel, the United States would be obliged, absent this provision, to extend to that United States corporation the benefits provided by the Convention. Since it is contrary to United States tax policy to restrict United States taxation of United States corporations by tax conventions, this paragraph removes such corporations from the scope of the substantive taxing provisions of the Convention.

The exceptions to the exclusion of dual resident corporations are necessary to make the Convention operate as intended. Dual resident corporations are given the benefits of the nondiscrimination provisions, and the competent authorities are given the authority to exchange information with respect to such corporations. The exception for Article 4(1) permits the United States to tax dividends paid to an Israeli resident by a corporation which is incorporated in the United States and is managed and controlled in Israel. Without this exception, the United States could not tax such dividends because of paragraph (1) of Article 6 (General Rules of Taxation) which states that a resident of one Contracting State may be taxed by the other only on income from sources in the other. The exception for Article 31 (Entry into Force) assures that the Convention will enter into force for dual resident corporations with respect to those provisions

for which they are covered. Situations of dual corporate residence should be infrequent.

ARTICLE 4
Source of Income

This Article contains the source rules which are to be used in applying the provisions of the Convention. Under Article 6 (General Rules of Taxation), one Contracting State may tax a resident of the other Contracting State only on income from sources within the first-mentioned Contracting State (provided, with certain exceptions, that the resident is not a citizen of the first-mentioned Contracting State).

Paragraph (1) provides that dividends will be treated as income from sources within a Contracting State only if paid by a corporation of that Contracting State.

Under paragraph (2), interest will be treated as income from sources within a Contracting State only if paid by that Contracting State, a political subdivision or a local authority thereof, or by a resident of that Contracting State. However, if interest is paid on an indebtedness incurred in connection with a permanent establishment which bears such interest, then such interest shall be deemed to be from sources within the State (whether or not a Contracting State) in which the permanent establishment is situated. This exception permits a Contracting State, under the proper circumstances, to impose a tax on interest paid by a permanent establishment therein, including a permanent establishment of a resident of a State other than a Contracting State. For example, if a resident of France has a permanent establishment in Israel which borrows money from a resident of the United States and bears the interest (i.e., deducts the interest in computing the income of the permanent establishment) the interest will be deemed to be from Israeli sources. Thus, Israel may tax such interest, subject to the limitations of Article 13 (Interest). As provided in paragraph (9) of Article 5 (Permanent Establishment) the principles of Article 5 will be applied to determine whether the resident of France has a permanent establishment in Israel. The United States will not, because of sections 861(a)(l)(C) and (D) of the Code, impose a tax on interest received by nonresident alien individuals or foreign corporations from a foreign corporation having a permanent establishment in the United States unless 50 percent or more of the gross income of such corporation from all sources for the three year period ending with the close of its taxable year preceding the payment of the interest (or such part of the period as the corporation has been in existence) vas effectively connected with the conduct of a trade or business within the United States.

In addition, the exception to the general rule of paragraph (2) of this Article will exempt interest from tax in the Contracting State in which the payor resides if the payor has a permanent establishment in a State other than a Contracting State in connection with which the indebtedness on which the interest is paid was incurred, such interest is borne by the permanent establishment and such interest is paid to a resident of the other Contracting State. This results from the restriction in Article 6 (General Rules of Taxation) that a resident of one Contracting State who is not a citizen of the other Contracting State may be taxed by the other Contracting State only on income from sources within that other Contracting State.

Paragraph (3) provides that royalties for the use of, or the right of use, property or rights described in paragraph (2) of Article 14 (Royalties) will be treated as income from sources within a Contracting State only to the extent that such royalties are for the use of, or the right to use, such property or rights within that Contracting State.

Paragraph (4) provides that income and gains (including royalties) to which Article 7 (Income from Real Property) applies will be treated as income from sources within a Contracting State only if the real property (or, in the case of property referred to in paragraph (3) of Article 7, the underlying real property) is situated in that Contracting State.

Paragraph (5) provides that income from the rental of tangible personal (movable) property will be treated as income from sources within a Contracting State only to the extent that the income is for the use of such property in that Contracting State.

Under paragraph (6), income from the purchase and sale, exchange, or other disposition of intangible or tangible personal property (other than gains described in paragraph (2) of Article 14 (Royalties)) will be treated as income from sources within a Contracting State only if such sale, exchange, or other disposition is within that Contracting State. However, gains from the sale, exchange, or other disposition of stock in an Israeli corporation to which paragraph (1)(e) of Article 15 (Capital Gains) applies will be treated as income from sources within Israel.

Under paragraph (7), income received by an individual for his performance of labor or personal services, whether as an employee or in an independent capacity, will be treated as income from sources within a Contracting State only to the extent that such services are performed In that Contracting State. Income from personal services performed aboard ships or aircraft operated by a resident of a Contracting State in international traffic will be treated as income from sources within that Contracting State if rendered by a member of the regular complement of the ship or aircraft. However, remuneration described in Article 22 (Governmental Functions) and payments described in Article 21 (Social Security Payments) paid from the public funds of a Contracting State or a political subdivision or local authority thereof will be treated as income from sources within that Contracting State only.

Paragraph (8) contains a general qualification to the preceding source rules. It provides that industrial or commercial profits attributable to a permanent establishment which the recipient, a resident of one Contracting State, has in the other Contracting State will be treated as income from sources within that other Contracting State. Industrial or commercial profits attributable to such permanent establishment may include any item of income described in paragraphs (1) through (6) if the item of income is effectively connected with the permanent establishment. See the discussion of paragraph (6) of Article 8 (Business Profits) for a discussion of the effectively connected concept.

Under paragraph (9), the source of any item of income not described in the preceding paragraphs of Article 4 will be determined by each Contracting State in accordance with its own law. However, if the source of any item of income under the laws of one Contracting State is different from its source under the laws of the other Contracting State or if its source is not readily determinable under the laws of one of the Contracting States, the competent authorities of

the Contracting State may, in order to prevent double taxation or further any other purpose of the Convention, establish a common source of the item of income for purposes of the Convention.

Several of the source rules set out in this Article differ to some degree from those provided in the Code. Since Article 6 (General Rules of Taxation) provides, in effect, that the Convention will not increase a person's overall United States tax, a taxpayer is not bound to apply the Convention rules in calculating his United States tax liability. However, a taxpayer may not make inconsistent choices between Code and Convention rules.

ARTICLE 5
Permanent Establishment

This Article defines the term "permanent establishment." The existence of a permanent establishment is relevant under Article 8 (Business Profits) to the taxation of industrial or commercial profits and In determining the applicability of other provisions of the Convention.

Under paragraph (1), the term "permanent establishment" means a fixed place of business through which a resident of one of the Contracting States engages in industrial or commercial activity. Illustrations in paragraph (2) of a fixed place of business include a branch; an office; a factory; a warehouse; a workshop; a farm or plantation; a store or other sales outlet; a mine, quarry or other place of extraction of natural resources; a building site, or construction or assembly project, or supervision activity connected therewith and conducted within the Contracting State where such site or project is located, where such site, project or activity continues for a period of more than six months; and the maintenance of substantial equipment or machinery, including for example, a drilling rig, within a Contracting State for a period of more than six months. As a general rule, any fixed facility or premises through which a resident conducts industrial or commercial activity for an indefinite or substantial period of time will be treated as a fixed place of business unless it is used only for one or more of the activities described in paragraph (3).

Under the building site or construction or installation project rule, the six months period begins only when work or supervision physically commences in the other Contracting State. A series of contracts or projects which are interdependent both commercially and geographically is to be treated as a single project for the purpose of applying the six months test.

Paragraph (3) specifically provides that a permanent establishment does not include a fixed place of business if it is used only for one or more of the following:

> "(a) The use of facilities for the purpose of storage, display, or delivery of goods or merchandise belonging to the resident;
>
> "(b) The maintenance of a stock of goods or merchandise belonging to the resident for the purpose of storage, display, or delivery (other than goods or merchandise held for sale by such resident in a store or other sales outlet);
>
> "(c) The maintenance of a stock of goods or merchandise belonging to the resident for the purpose of processing by another person;
>
> "(d) The maintenance of a fixed place of business for the purpose of

purchasing goods or merchandise, or for collecting information for the resident;

"(e) The maintenance of a fixed place of business for the purpose of advertising, for the supply of information, for scientific research, or for similar activities which have a preparatory or auxiliary character, for the resident;

"(f) A building site, or construction or assembly project, or supervision activity connected therewith, where such site, project, or activity continues for a period of not more than 6 months, or

"(g) The maintenance of substantial equipment or machinery within a Contracting State for a period of not more than 6 months."

As noted, a fixed place of business used only for one or more of these purposes will not be considered a permanent establishment under the Convention. The exception of paragraph (3)(b) relating to the maintenance of a stock of goods or merchandise for the purpose of storage, display, or delivery contains language which makes clear that goods held for sale in a store or other sales outlet are not included in the exception. This emphasizes the rule that goods held in a store or other sales outlet are not merely being held for storage, display or delivery.

Paragraph (4) provides that even though a resident of one Contracting State does not have a permanent establishment in the other Contracting State under paragraphs (1), (2), and (3), such resident will be deemed to have a permanent establishment in the other Contracting State if such resident sells in that Contracting State goods or merchandise which either were subjected to substantial processing in that Contracting State (whether or not purchased in that Contracting State), or were purchased in that Contracting State and not subjected to substantial processing outside that Contracting State.

Under paragraph (5), a person acting in one Contracting State on behalf of a resident of the other Contracting State, other than an agent of an independent status to whom paragraph (6) applies, will be deemed to constitute a permanent establishment if such person has, and habitually exercises in that first-mentioned Contracting State, an authority to conclude contracts in the name of the resident, unless the exercise of the authority is limited to the purchase of goods or merchandise for the resident.

On the other hand, paragraph (6) provides that a resident of one Contracting State will not be deemed to have a permanent establishment in the other Contracting State merely because such resident engages in industrial or commercial activity in such other Contracting State through a broker, general commission agent, or any other agent of an independent status, where such broker or agent is acting in the ordinary course of his business.

Paragraph (7) provides that a resident of one Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because such resident sells at the termination of a trade fair or convention in the other Contracting State goods or merchandise which were displayed by such resident at the trade fair or convention. The trade fair exception is not intended to apply with respect to goods in the resident's inventory.

Under paragraph (8), the determination of whether a resident of one Contracting State has a permanent establishment in the other Contracting State is to be made without regard to the fact

that such resident may be related to a resident of the other Contracting state or to a person who engages in business in that other Contracting State (whether through a permanent establishment or otherwise). What is relevant is whether the resident of the other State carries on for the resident of the first-mentioned state an activity which, within the provisions of this Article, would make the resident of the other State a dependent agent of the resident of the first-mentioned State. As defined in Article 11 (Related Persons), a person is related to another person if either person owns or controls directly or indirectly the other, or if a third person or persons own or control directly or indirectly both.

Paragraph (9) provides that the principles set forth in this Article are to be applied in determining whether there is a permanent establishment in a State other than one of the Contracting States or whether a person other than a resident of one of the Contracting States has a permanent establishment in one of the Contracting States. This is necessary for the proper application of paragraph (2) of Article 4 (Source of Income). This paragraph is not intended to extend the benefits of the Convention to persons other than residents of the two Contracting States.

ARTICLE 6
General Rules of Taxation

Under paragraph (1), a resident of one Contracting State may be taxed by the other Contracting State on any income from sources within that other Contracting State and only on such income, subject to the limitations set forth in the Convention. For this purpose, the source rules contained in Article 4 (Source of Income) are to be applied. However, if the resident is a citizen of the other Contracting State, that Contracting State may tax the resident without regard to this paragraph because of the saving clause of paragraph (3) of this Article.

Paragraph (2) contains the customary rule that the Convention will not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance now or hereafter accorded by the laws of a Contracting State in the determination of a tax imposed by it, or by any other agreement between the Contracting States. Thus, if a deduction would be allowed under the Code for an item in computing the taxable income of an Israeli resident, such deduction is generally available to him in computing taxable income under the Convention. Paragraph (2) does not, however, authorize a taxpayer to make inconsistent choices between rules of the Code and rules of the Convention. In no event are the rules of the Convention to increase the U.S. or Israeli tax burden from what that liability would be if there were no Convention. Thus, a right to tax given by the Convention cannot be exercised unless that right also exists under the Code.

Paragraph (3) contains the traditional saving clause under which the United States reserves the right to tax its citizens and residents (determined under Article 3 (Fiscal Residence)) as if the Convention had not come into effect. However, under paragraph (4), the saving clause does not apply in several cases in which its application would contravene policies reflected in the Convention. These policies are specifically designed to extend treaty benefits to citizens or residents. Thus, the saving clause does not affect the provisions with respect to grants, charitable contributions, social security payments$_1$ relief from double taxation, nondiscrimination, or the

mutual agreement procedure, which are available to residents and citizens of the Contracting States. Moreover, the saving clause does not affect the benefits of the Convention provided to individuals performing governmental functions, teachers, students and trainees, and diplomatic or consular officers who are neither citizens of, nor have immigrant status in, the Contracting State imposing the tax. In the case of the United States, "immigrant status" means the individual has been admitted to the United States for permanent residence. The saving clause is reciprocal.

Paragraph (5) reserves the right of the United States to impose its personal holding company tax under section 541 of the Code and its accumulated earnings tax under section 531 of the Code notwithstanding any provision of the Convention. However, paragraph (5) also provides that an Israeli corporation will be exempt from the personal holding company tax in any taxable year unless United States residents or citizens own, directly or indirectly, within the meaning of section 544 of the Code, ten percent or more in value of the outstanding stock of the corporation at any time during the taxable year. In addition, an Israeli corporation will be exempt from the accumulated earnings tax in any taxable year unless at least twenty-five percent of the voting stock of such corporation is owned by United States citizens or residents.

Paragraph (6) provides a special rule for cases where income dealt with by this Convention is taxable to a resident of a Contracting State only if, and to the extent, it is remitted to or received by that person. In certain cases, individuals who are residents of Israel are not taxable on foreign source investment income, unless it is remitted to or received by them in Israel. If such income is received outside of Israel or accumulated by the payer, an Israeli resident may not be subject to tax on that income. If the reductions in rates or exemptions from tax were to apply to those items of income, the United States would be foregoing tax where double taxation does not in fact occur. Thus, this paragraph provides that if under the law in the other Contracting State income would only be taxed on & remittance basis, then any reduced rates of tax provided by this Convention shall apply only to the extent such income is remitted to or received by the person in that other Contracting State in the year in which it accrues to the benefit of that taxpayer. This rule applies to all persons, including individuals, corporations, partnerships and trusts or estates taxable as such.

Paragraph (7) authorizes the competent authorities of the Contracting States to prescribe regulations necessary to carry out the provisions of the Convention. For the United States, this authority is also provided by section 7805 of the Code.

ARTICLE 7
Income from Real Property

Under paragraph (1), income from real property, including royalties and other payments in respect of the exploitation of natural resources (e.g., oil wells) and gains from the sale, exchange or other disposition of such property or of the right giving rise to such royalties or other payments, may be taxed by the Contracting State in which the real property or natural resources are situated. Thus, natural resource royalties are covered under this Article and not under Article 14 (Royalties). However, income from real property does not include interest on indebtedness secured by real property (e.g., mortgages) or secured by a right giving rise to

royalties or other payments in respect of the exploitation of natural resources. Such interest income is covered by Article 13 (Interest). The rule of this paragraph, however, does not confer an exclusive right of taxation on the State where the property is located.

Under paragraph (2), paragraph (1) applies to income derived from the usufruct, direct use, letting, or use in any other form of real property.

Paragraph (3) provides, consistent with U.S. law, that gains from the alienation of shares of a company the property of which consists, directly or indirectly, principally of real property situated in a Contracting State may be taxed by that State. Paragraph (4) of Article 4 (Source of Income) provides that these gains will be considered from sources within a Contracting State if the real property owned by the company is situated in that State.

This Article does not contain a provision allowing for the taxation of real property income on a net basis. This is because such treatment is already provided for under the laws of both Contracting States.

ARTICLE 8
Business Profits

Paragraph (1) sets forth the general rule that industrial or commercial profits of a resident of one Contracting State are exempt from tax by the other Contracting State unless the resident has a permanent establishment in the other Contracting State. Where there is a permanent establishment, only the industrial or commercial profits attributable to the permanent establishment can be taxed by that other Contracting State, unless the resident is a citizen of that other Contracting State. (See the saving clause in paragraph (3) of Article 6 (General Rules of Taxation).) Under paragraph (8) of Article 4 (Source of Income), industrial or commercial profits, whether otherwise treated as from sources within or without a Contracting State, which are attributable to a permanent establishment which a resident of one Contracting State has in the other Contracting State will be considered to be from sources within that other Contracting State. Thus, items of income described in section 864(c)(4)(B) of the Code attributable to a permanent establishment situated in the United States will be subject to tax by the United States. The limited “force of attraction” rule under Code section 864(c)(3) does not apply for U.S. tax purposes under the Convention.

In determining the proper attribution of industrial or commercial profits under the Convention, paragraph (2) provides that both Contracting states will attribute to the permanent establishment such profits as it would reasonably be expected to derive if it were an independent entity engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the resident of which it is a permanent establishment. Under paragraph (3), expenses, wherever incurred, which are reasonably connected with profits attributable to the permanent establishment, including executive and general administrative expenses, will be allowed as deductions in determining the industrial or commercial profits of the permanent establishment. However, in determining the amount of the deduction under paragraph (3) for expenses incurred by the head office, the deductions may be limited to the

expense incurred without including a profit element for the head office.

Paragraph (4) provides that no profits shall be attributed to & permanent establishment merely because of the purchase of goods or merchandise by that permanent establishment, or by the resident of which it is a permanent establishment, for the account of such resident. Paragraph (2) of the Article does not override paragraph (4). Thus, where a permanent establishment purchases goods for its head office, the industrial and commercial profits attributed under paragraph (2) to the permanent establishment with respect to its other activities will not be increased by adding a notional figure for profits from purchasing.

Under paragraph (5), the term "industrial or commercial profits" includes income derived from manufacturing, mercantile, banking, insurance, agricultural, fishing or mining activities, the operation of ships or aircraft, the furnishing of services, and the rental of tangible personal (movable) property. The term does not include income from the rental or licensing of motion picture films or films or tapes used for radio or television broadcasting, or income from the performance of personal services derived by an individual either as an employee or in an independent capacity.

Under paragraph (6), the term "industrial and commercial profits" also includes income from dividends, interest, royalties described in paragraph (2) of Article 14 (Royalties), and capital gains and income derived from property and natural resources, but only if the income is effectively connected with a permanent establishment. See paragraph (4) of Article 12 (Dividends), paragraph (5) of Article 13 (Interest), paragraph (3) of Article 14 (Royalties) and paragraph (l)(c) of Article 15 (Capital Gains).

Paragraph (6) also contains criteria for determining whether income is effectively connected with a permanent establishment. Factors to be taken into account include whether the rights or property giving rise to such income are used in, or held for use in, carrying on an activity giving rise to industrial or commercial profits through a permanent establishment and whether the activities carried on through such permanent establishment were a material factor in the realization of the income. For this purpose, due regard will be given to whether or not such property or rights or such income were accounted for through such permanent establishment. The rules of this paragraph are similar to those found in section 864 of the Code.

Under paragraph (7), where industrial or commercial profits include items of income which are dealt with separately in other articles of the Convention, the provisions of those articles will, except as otherwise provided therein, supersede the provisions of this Article. Thus, for example, taxation of interest income will be controlled by Article 13 (Interest) and not by this Article unless the interest is attributable to a permanent establishment.

Paragraph (8) provides that the United States excise tax on insurance premiums paid to foreign insurers, imposed by section 4371 of the Internal Revenue Code, which is a covered tax under paragraph (l)(a) of Article 1 (Taxes Covered), will not apply to insurance or reinsurance premiums received by a business of insurance conducted by a resident of Israel regardless of whether that business is carried on through a permanent establishment in the United States. This provision applies only to the extent that the relevant risk ii not reinsured, directly or indirectly,

with a person not entitled to relief from such tax.

Under paragraph (1) of Article 8 (Business Profits) and subparagraph (1)(a) of Article 1 (Taxes Covered) of the Convention, no insurance excise tax (or income tax) is payable with respect to premiums paid to a resident of Israel if the resident does not have a permanent establishment in the United States. In the case of an resident of Israel with a permanent establishment in the United States, the United States will not impose the insurance excise tax. (See Revenue Ruling 80-225.)

ARTICLE 9
Shipping and Air Transport

Paragraph (1) provides that, notwithstanding Article 8 (Business Profits) and Article 15 (Capital Gains), income derived by a resident of one Contracting State from the operation in international traffic of ships or aircraft, and gains derived from the sale, exchange or other disposition of such ships or aircraft, shall be exempt from tax by the other Contracting State. It should be noted that income derived by a resident of Israel would be exempt from tax by the United states even though the vessel with respect to which the income is earned is registered in a State which would not qualify for the reciprocal exemption of Code sections 872(b) and 883(a).

Under paragraph (2), this Article applies to income derived from the rental of such ships or aircraft under a full or bareboat charter if the lessor is engaged in the operation of ships or aircraft in international traffic and the rental income is incidental to such operations of the lessor. For example, if an airline which is a resident of one Contracting State has excess equipment in the winter months and leases several of its aircraft which are not required by it during that period to an airline which is a resident of the other Contracting State, that rental income of the lessor is not subject to tax by that other Contracting State.

Paragraph (2) also makes clear that the Article applies to income derived by a resident of one Contracting State from the use, maintenance, and lease of containers, trailers for the inland transportation of containers and other related equipment in connection with the operation by a resident in international traffic of ships or aircraft described in paragraph (1).

This Article is subject to the saving clause of paragraph (3) of Article 6 (General Rules of Taxation). Therefore, a Contracting State may tax income from international traffic derived by a resident of the other Contracting State without regard to this Article if such resident is a citizen of the first-mentioned Contracting State.

ARTICLE 10
Grants

This Article details the manner in which Israeli governmental grants to United States residents will be treated for United States tax purposes.

Paragraph (1) provides that for the purpose of computing United States tax, if Israel, a political subdivision thereof, or any agency of either makes a qualifying cash grant to a United States resident, then the amount of such grant will be included in the gross income of such resident unless the U.S. resident elects to exclude it. If he does not so elect, and the grant is included in income, the U.S. resident would increase his basis in the stock of the Israeli corporation by the amount of the grant. If he so elects, and if the resident is a corporation, the amount of such grant will be treated as a contribution to its capital. The electing United States resident will be considered to have contributed the amount of such grant to the Israeli corporation designated by the terms of the grant, and the resident's basis for the stock of the Israeli corporation will not be increased by the amount of the contributed grant. The basis of the assets of the Israeli corporation (for purposes of determining the Israeli subsidiary's earnings and profits for U.S. tax purposes) will be reduced by the amount of the deemed contribution, in accordance with rules prescribed by the Secretary of the Treasury. The Convention has no special provision with respect to a U.S. resident who acquires assets directly from the proceeds of a grant. Thus, for example, if the U.S. resident is a corporation, the rules of section 362(c) of the Code will apply and the U.S. resident will be required to reduce its basis in certain assets acquired after the contribution.

Paragraph (2) defines a qualifying cash grant as one approved by Israel for investment promotion in Israel. A qualifying grant will not include any amount which in whole or part, directly or indirectly,

(a) is in consideration for services rendered or to be rendered by either the United States resident or the Israeli subsidiary, or for the sale of goods;

(b) is measured in any manner by the amount of profits or tax liability of the investor or the Israeli corporation in which the investment is made; or

(c) which is taxed by Israel.

A grant will qualify where It is made by Israel, or a political subdivision thereof, on the basis of the enterprise meeting an approved project's social or economic objectives, which may include, for example, creating employment, generating or conserving foreign exchange, tourism, or developing less developed regions. It is contemplated that qualifying grants may be made before commencement of an investment or after the investment has been made and may be based upon whether or not the enterprise has fulfilled the conditions of investment.

ARTICLE 11
Related Persons

This Article complements section 482 of the Code and confirms the authority of the United States under that section. Where a person subject to the taxing jurisdiction of a Contracting State (whether or not a resident thereof) and any other related person make arrangements or impose conditions between themselves which are different from those which would be made between independent persons, under paragraph (1), any income, deductions, credits or allowances which would, but for those arrangements or conditions, have been taken into account in computing the income or loss of, or the tax payable by, one of such persons, say be taken into account in computing the amount of the income subject to tax and the taxes payable

by such person in that Contracting State.

Paragraph (2) sets forth an explicit formulation of the consequence of a redetermination made in accordance with paragraph (1) by a Contracting State to the income of one of its residents. In such event, the other Contracting State will, if it agrees with such redetermination and if necessary to prevent double taxation, make a corresponding adjustment to the income of a person in such other Contracting State related to such resident. If the other Contracting State disagrees with the redetermination, the two Contracting States will endeavor to reach agreement in accordance with the mutual agreement procedure in paragraph (2) of Article 28 (Mutual Agreement Procedure).

Paragraph (3) provides that for purposes of the Convention a person is related to another person if either person owns or controls directly or indirectly the other, or if a third person or persons own or control directly or indirectly both. ”Control” includes any kind of control, whether or not legally enforceable, and however exercised or exercisable.

ARTICLE 12
Dividends

Paragraph (1) provides that dividends derived from sources within one Contracting State by a resident of the other Contracting State may be taxed by both Contracting States.

Paragraph (2) limits the rate of tax in the Contracting State of source, in general, to a rate not in excess of twenty-five percent of the gross amount of the dividend paid. However, if the dividend recipient is a corporation, two special rules are provided. Under subparagraph (2)(b), where the dividend is paid out of income for a period during which the paying corporation is not entitled to the reduced rate of tax applicable to an approved enterprise under Israel's Encouragement of Capital Investments Law (1959), the rate of tax in the Contracting State of source may not exceed twelve and one-half percent of the gross amount of the dividend paid. Under subparagraph (2)(c), a maximum rate of 15 percent of the gross dividend is provided for dividends paid for a period during which the paying corporation is entitled to the reduced rates applicable to an approved enterprise under Israel's Encouragement of Capital Investments Law (1959). These special rate limitations only apply if during the part of the paying corporation's taxable year which precedes the date of payment of the dividend and during the whole of its prior taxable year (if any), at least ten percent of the outstanding voting stock of the corporation was owned by the recipient corporation, and not more than twenty-five percent of the gross income of the paying corporation for such prior taxable year (if any) consists of interest or dividends (other than interest derived from the conduct of a banking, insurance, or financing business and dividends or interest received from subsidiary corporations, fifty percent or more of the outstanding voting stock of which is owned by the paying corporation at the time such dividends or interest is received). These rate limitations do not affect the taxation of profit of the company which pays the dividends.

Paragraph (3) provides that dividends paid by a corporation of one Contracting State to a person other than a resident of the other Contracting State (and in the case of dividends paid by

an Israeli corporation, to a person other than a citizen of the United States) will be exempt from tax by the other Contracting State.

Paragraph (4) provides that the limitations of paragraphs (2) and (3) will not apply if the dividends are treated, under paragraph (6) of Article 8 (Business Profits), as industrial or commercial profits attributable to a permanent establishment which the recipient has in the other Contracting State. In such case, the provisions of Article 8 (Business Profits) will apply. If the recipient of the dividend is a citizen of the source Contracting State, that Contracting State may tax the recipient without regard to this Article because of the saving clause of paragraph (3) of Article 6 (General Rules of Taxation).

No definition of the term "dividends" is provided. Accordingly, each Contracting State may use the definition under its domestic law, unless the context otherwise requires or the competent authorities agree to a common meaning. See paragraph (2) of Article 2 (General Definitions).

ARTICLE 13
Interest

Paragraph (1) provides that interest derived by a resident of one Contracting State from sources within the other Contracting State may be taxed by both Contracting States. However, paragraph (2) limits the rate of tax in the Contracting State of source to a rate not in excess of seventeen and a half percent of the gross amount of the interest. If the interest is derived from a loan of whatever kind granted by a bank, savings institution, insurance company, or the like, the rate of tax in the Contracting State of source may not exceed ten percent of the gross amount of the interest.

Paragraph (3) provides that interest beneficially derived by one of the Contracting States, or by an instrumentality of that Contracting State not subject to tax by that Contracting State on its income, will be exempt from tax by the other Contracting State. Under this rule, interest income derived by the Export-Import Bank of the United States and the Overseas Private Investment Corporation (OPIC) on loans made to Israeli residents will be exempt from tax in Israel. Similarly, income derived by the Bank of Israel on loans made to residents of the United States will be exempt from U.S. tax. The exemption also applies where a resident of a Contracting State receives interest income with respect to debt obligations guaranteed or insured by that Contracting State or an instrumentality thereof.

Paragraph (4) provides that interest paid by a resident of one Contracting State to a person other than a resident of the other Contracting State (and in the case of interest paid bye resident of Israel, to a person other than a United States citizen) will be exempt from tax by the other Contracting State unless such interest is treated as income from sources within the other Contracting State under paragraph (2) of Article 4 (Source of Income).

Paragraph (5) provides that the limitations of paragraphs (2), (3), and (4) will not apply if the interest is treated, under paragraph (6) of Article 8 (Business Profits), as industrial or

commercial profits attributable to a permanent establishment which the recipient has in the other Contracting State. In such a case, the provisions of Article 8 (Business Profits) will apply.

If excessive interest is paid to a related person, paragraph (6) provides that the Article does not apply to the excessive portion of the payment. The excessive portion may be taxed by each Contracting State according to its own laws, including the Convention where applicable. In the case of the United States, the excessive portion may be taxed as a dividend, in which case the provisions of Article 12 (Dividends) will apply.

Paragraph (7) defines “interest” for purposes of the Convention as income from money lent and other income which under the taxation law of the Contracting State in which the income has its source is assimilated to income from money lent.

This Article is subject to the saving clause of paragraph (3) of Article 6 (General Rules of Taxation). Therefore, interest derived by a citizen of the source Contracting State may be taxed by that Contracting State without regard to this Article.

ARTICLE 14
Royalties

Paragraph (1) provides that royalties derived by a resident of one Contracting State from sources within the other Contracting State may be taxed by both Contracting States. However, paragraph (1) limits the tax in that other Contracting State to a rate not to exceed ten percent of the gross amount of a copyright or film royalty or fifteen percent of the gross amount of an industrial royalty.

The term "copyright or film royalties" is defined in paragraph (2)(a) as payments of any kind made as consideration for the use of, or the right to use, copyrights of literary, artistic, or scientific works, including copyrights of motion picture films or films or tapes used for radio or television broadcasting. The term "industrial royalties" is defined in paragraph (2)(b) as payments of any kind made as consideration for the use of, or the right to use, patents, designs, models, plans, secret processes or formulae, trademarks, or other like property or rights. Copyright or film royalties and industrial royalties include gains derived from the sale, exchange, or other disposition of such property or rights to the extent the amounts realized on such sale, exchange or other disposition for consideration are contingent on the productivity, use, or disposition of the property or rights. If the amounts realized are not so contingent, the provisions of Article 15 (Capital Gains) may apply. The term "royalties" does not include royalties and other payments in respect of the exploitation of natural resources. Such payments are covered by the provisions of Article 7 (Income from Real Property). See also paragraph (6) of Article 8 (Business Profits).

Paragraph (3) provides that the tax rate limitations of paragraph (1) shall not apply if the royalty is treated, under paragraph (6) of Article 8 (Business Profits), as industrial or commercial profits attributable to a permanent establishment which the recipient has in the other Contracting State. In such a case, the provisions of Article 8 (Business Profits) will apply.

If excessive royalties are paid to a related person, paragraph (4) provides that the Article does not apply to the excessive portion of the royalty. The excessive portion may be taxed by each Contracting State according to its own laws, including the Convention where applicable. Thus, the excessive portion may be treated as a dividend or interest, or in whatever other manner is appropriate. But if, for example, it is treated as a dividend, the rules of Article 12 (Dividends) will be applied.

As noted under paragraph (3) of Article 4 (Source of Income), royalties (including contingent gains) will be treated as income from sources within a Contracting State only to the extent they are payments made as consideration for the use of, or the right to use, property or rights described in paragraph (2) within that Contracting State. This source rule is similar to the source rule in section 861(a)(4) of the Code.

This Article is subject to the saving clause of paragraph (3) of Article 6 (General Rules of Taxation). Therefore royalties derived by a citizen of the source Contracting State may be taxed by that Contracting State without regard to this Article.

ARTICLE 15
Capital Gains

Under paragraph (1), a resident of one Contracting State will be exempt from tax by the other Contracting State on gains from the sale, exchange or other disposition of capital assets. However, the exemption does not apply if

(a) the gain is from the sale, exchange or other disposition of property described in Article 7 (Income from Real Property) situated within the other Contracting State;

(b) the gain is from the sale, exchange or other disposition of property described in paragraph (2)(c) of Article 14 (Royalties);

(c) the gain is treated, under paragraph (6) of Article 8 (Business Profits), as industrial or commercial profits attributable to permanent establishment which the resident has in the other Contracting State; or

(d) the resident is an individual who is present in the other Contracting State for a period or periods aggregating 183 days or more during the taxable year.

For purposes of this Article and the other physical presence tests contained in the Convention with regard to an individual, the term "day" means a calendar day during any portion of which the individual is physically present in the relevant Contracting State.

Paragraph (1) contains an additional exception to the capital gains exemption which is not in previous United States conventions. Under Israeli tax law, gains from the sale of stock in an Israeli corporation are subject to tax by Israel regardless of the residence of the alienator or place where the sale occurs. The additional exception in paragraph (1) is intended to limit this rule of Israeli taxation. This exception will apply (i.e., Israel will preserve its right to tax) only if the gain is derived from the sale, exchange or other disposition of stock in an Israeli corporation by a resident of the United states who owns either actually or constructively within the twelve

month period preceding the sale, exchange, or other disposition, stock possessing more than fifty percent of the voting power of the Israeli corporation, and more than fifty percent of the fair market value of the Israeli corporation's gross assets used in its trade or business are physically located in Israel on the last day of each of the three taxable years preceding the sale, exchange, or other disposition (or, if the corporation has been in existence for less than three years, on the last day of each preceding taxable year of the corporation).

Paragraph (2) provides that the provisions of Article 7 (Income from Real Property) will apply to real property gains; the provisions of Article 14 (Royalties) will apply to certain royalty gains; and the provisions of Article 8 (Business Profits) will apply to gains attributable to a permanent establishment.

If the recipient of the gain is a resident of one Contracting State and a citizen of the other Contracting State, that other Contracting State may tax the recipient without regard to this Article because of the saving clause of paragraph (3) of Article 6 (General Rules of Taxation). Where Article 9 (Shipping and Air Transport) applies to gains derived from the sale, exchange or other disposition of property, this Article does not apply to such gains.

ARTICLE 15-A
Charitable Contributions

Article 15-A provides rules under which a resident of one Contracting State (and, in the case of the United States, a U.S. citizen) may make a gift to a charitable organization in the other State, which will be treated for tax purposes, by the State of residence (or citizenship in the case of the United States) as a charitable contribution.

Paragraph (1) deals with the U.S. tax treatment of gifts by U.S. citizens or residents to Israeli charities. It provides that if a U.S. citizen or resident makes a contribution to an organization created or organized under the laws of Israel, that contribution will be treated as a charitable contribution for U.S. tax purposes, for the taxable year in which the gift is made, if and to the extent that the contribution would have been so treated if the organization had been created or organized under the laws of the United States. This rule applies, however, only to contributions which do not exceed twenty-five percent of the contributor's taxable income (if a corporation) or adjusted gross income (if an individual) for the year from Israeli sources.

Paragraph 2 applies, *mutatis mutandis*, to a gift by an Israeli resident to an American organization.

The Article determines whether any particular gift is to be treated as a charitable contribution. Whether, or the extent to which a deduction (or, in the case of Israel, a credit) is to be allowed by the country of residence for the contribution continues to be governed by the limitations in the taxation laws of that Contracting State. For example, assume a U.S. resident with $50,000 of adjusted gross income, $10,000 of which is from Israeli sources. His contributions to U.S. charitable organizations total $25,000, and he contributes $5,000 to

qualifying Israeli organizations. Assume, further, that all the contributions qualify under Code section 170(b)(l)(A) and are, therefore, deductible up to fifty percent of adjusted gross income. His charitable contributions, under paragraph (1) of the Article, would be $27,500--the full $25,000 of contributions to U.S. organizations and $2,500 (twenty-five percent of $10,000) of contributions to Israeli charities. His limit for current year deductions under U.S. law is $25,000. Thus, he may deduct $25,000 in the current year and carry over $2,500 for future years. Once a contribution to an Israeli charitable organization qualifies as a charitable contribution it becomes indistinguishable from other charitable contributions. There is no need, therefore, in the example above, to determine whether the carryover of excess contributions reflects contributions to Israeli or American charities. Thus, even if the contributor has no Israeli source income in future years, his right to use the carryover is not affected.

In notes exchanged at the time of the signing of the treaty, it was agreed that an effort would be made to develop procedures to simplify the determination by one Contracting State that an organization in the other Contracting State is eligible to receive charitable contributions from residents of the first-mentioned State. The competent authorities of each Contracting State will review the procedures and requirements of the other Contracting State for certifying an organization of that other State as eligible to receive charitable contributions. If the competent authorities find that the procedures do not differ substantially as between the two Contracting States, it is contemplated that the authorities of each State will accept certification by the other and will not require recipient organizations to qualify separately in both States.

ARTICLE 16
Independent Personal Services

In dealing with the taxation of income from personal services the Convention distinguishes between "independent" and "dependent" personal services. The Convention also provides special treatment for individuals who are "public entertainers" and for amounts received for furnishing the personal services of others.

Services performed by an individual in an independent capacity are services performed for his own account where he receives the income and bears the losses arising from such services. If an individual is an independent contractor he is considered as rendering independent personal services. Generally, services rendered by physicians, lawyers, engineers, architects, dentists and accountants performing personal services as sole proprietors or partners are independent personal services.

Under paragraph (1), income derived by an individual resident of one contracting State from the performance of personal services in an independent capacity may be taxed only by that Contracting State. However, under paragraph (2), such income derived from services performed in the other contracting State may also be subject to tax in that other contracting State if the individual is present therein for a period or periods aggregating 183 days or more in the taxable year. Under the saving clause of paragraph (3) of Article 6 (General Rules of Taxation), the other Contracting State may also tax any individual who is a citizen of that other contracting State without regard to this Article.

ARTICLE 17
Dependent Personal Services

Under paragraph (1), wages, salaries, and similar remuneration derived by an individual who is a resident of one Contracting State from labor or personal services performed as an employee, including income from services performed by an officer of a corporation or company, may be taxed by that Contracting State. If such remuneration is derived from sources within the other Contracting State, it may be taxed by that other contracting State unless it is exempt from tax in that other State under paragraph (2) or under Articles 20 (private Pensions and Annuities), 22 (Governmental functions), 23 (Teachers) and 24 (Students and Trainees).

Under paragraph (2), dependent personal service income derived by an individual resident of one contracting State will be exempt from tax by the other contracting State if:

(a) the individual is present in that other contracting State for a period or periods aggregating less than 183 days in the taxable year;

(b) the individual is an employee of a resident of the first-mentioned contracting State or of a permanent establishment maintained in the first-mentioned Contracting State;

(c) the remuneration is not borne as such (i.e., as a deduction for salary payments) by a permanent establishment which the employer has in the other contracting State; and

(d) the remuneration is subject to tax in the first-mentioned Contracting State. Income of a United States citizen or resident which is excluded from tax by reason of section 911 is not considered subject to tax by the United States.

Such income may also be taxed by that other contracting state without regard to this Article if the individual is a citizen of that other contracting State, because of the saving clause of paragraph (3) of Article 6 (General Rules of Taxation).

Under paragraph (3), and notwithstanding paragraphs (1) and (2), remuneration derived by an employee (even if a resident of a State other than a Contracting State) of a resident of one Contracting State for labor or personal services performed as a member of the regular complement of a ship or aircraft operated in international traffic by a resident of that Contracting State may be taxed by that Contracting State. In addition, this paragraph is subject to the saving clause of paragraph (3) of Article 6 (General Rules of Taxation) so that the other Contracting State may tax its citizens or residents without regard to this paragraph.

ARTICLE 18
Public Entertainers

This Article provides that, notwithstanding Articles 16 (Independent Personal Services) and 17 (Dependent Personal Services), income derived by an individual resident in one Contracting State from his performance of personal services in the other Contracting State as a public entertainer, such as a theater, motion picture, radio or television artist, a musician, or an

athlete may be taxed by the other Contracting State only if the gross amount of such income exceeds $400 or its equivalent in Israeli pounds for each day the individual is present in the other Contracting State for the purpose of performing such services therein. If the entertainer's gross income exceeds $400 per day, he may be taxed on the full amount of his income, not just the amount in excess of $400.

If the individual receives a fixed amount for performing the services on more than one day, the amount received will be pro-rated over the number of days the individual performs the services. Thus, for example, if am entertainer resident in Israel receives $5,000 to perform in a series of 5 concerts in the United States on 5 different days and spends an additional 5 days in the United States in rehearsal for those concerts over a two week period, he will be considered to have received $500 for each day and thus, pursuant to this Article, he may be taxed by the United States.

Income derived from services rendered by producers, directors, technicians, and others who are not public entertainers is taxable in accordance with the provisions of Article 16 (Independent Personal Services), or Article 17 (Dependent Personal Services), as the case may be.

Under the saving clause of paragraph (3) of Article 1 (General Rules of Taxation), if the individual is a citizen of a Contracting State, that State may tax his income without regard to this Article.

ARTICLE 19
Amounts Received for Furnishing Personal Services of Others

Paragraph (1) provides that amounts received by a resident of one Contracting State in consideration of furnishing in the other Contracting State the personal services of one or more other persons, including a public entertainer referred to in Article 18 (Public Entertainers), will not constitute industrial or commercial profits under Article 8 (Business Profits) to the extent that the person for whom the services were furnished designated the person or persona who would render the services, whether or not he had the legal right to do so and whether or not the designation was made formally; the person for whom the services were furnished had the right to designate the person or persons who would render the services; or by reason of the facts and circumstances the arrangement for personal services had the effect of designating the person or persons who would render the services; and the resident of the first-mentioned Contracting State directly or indirectly pays compensation for such services to any person, other than another resident of the first-mentioned Contracting State or of that other Contracting State who is subject to tax on such compensation. If this paragraph applies, the amounts received for providing personal services of other individuals in the other Contracting State may be taxed by that other Contracting State even though not attributable to a permanent establishment. For purposes of this paragraph, income of a United States citizen or resident which is excluded from tax by reason of section 911 is not considered subject to tax by the United States.

Paragraph (2) provides that paragraph (1) will not apply if it is established to the

satisfaction of the competent authority of that other Contracting state with respect to any amount received that neither the creation nor organization of the resident of the first-mentioned Contracting State (where such resident is a corporation or other entity) nor the furnishing of the services through such resident has the effect of a substantial reduction in income, war profits, excess profits, or similar taxes. The taxes referred to in the preceding sentence are those imposed by the two Contracting States.

ARTICLE 20
Private Pensions and Annuities

Except as provided in Article 22 (Governmental Functions), pensions and other similar remuneration paid to an individual will be taxable under paragraph (1) only in the Contracting 8tate of which he is a resident. Thus, private pensions and similar remuneration derived from sources within one Contracting State by an individual resident of the other Contracting State are exempt from tax in the first-mentioned Contracting State. Pensions for Government service are dealt with in Article 22 (Governmental Functions). The term “pensions and similar remuneration” is defined in paragraph (4) am periodic payments, other than social security payments covered in Article 21 (Social Security Payments), made by reason of retirement or death and in consideration for services rendered, by way of compensation for injuries or sickness received in connection with past employment, or by reason of payments made under a plan benefitting self-employed individuals all or some of the contributions to which qualify for special tax treatment.

Paragraph (2) provides that alimony and annuities paid to an individual resident of a Contracting State will be taxable only in that Contracting State. The term “annuities” is defined in paragraph (5) as a stated sum paid periodically at stated times during life, or during a specified number of years, under an obligation to make the payments in return for adequate and full consideration (other than for services rendered). The term “alimony” is defined in paragraph (6) as periodic payments made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support which are taxable to the recipient under the internal laws of the Contracting State of which he is a resident. Thus, the term “alimony” would not include a payment which would not be taxable to the recipient under the laws of the Contracting State in which he is a resident even though such payment is made pursuant to a decree of divorce or of separate maintenance. The explicit reference to a decree of compulsory support is consistent with section 71 of the Code.

Paragraph (3) provides that child support payments made by an individual resident of one Contracting State to an individual resident of the other Contracting State will be exempt from tax in that other Contracting State. The term “child support payments” is defined in paragraph (7) as periodic payments for the support of a minor child made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support.

This Article is subject to the saving clause of paragraph (3) of Article 6 (General Rules of Taxation). Therefore, individuals who are citizens or residents of a Contracting State may be taxed by that Contracting State without regard to this Article.

ARTICLE 21
Social Security Payments

This Article provides that social security payments and other public pensions, e.g., railroad retirement benefits, paid by one Contracting State to an individual who is a resident of the other Contracting State will be exempt from tax in both Contracting States. Payments described in Article 22 (Governmental Functions) are not covered by this Article.

Under paragraph (2) of Article 32 (Termination), this Article may be terminated by either Contracting State at any time after the Convention enters into force.

Under paragraph (4)(a) of Article 6 (General Rules of Taxation), the saving clause of paragraph (3) of Article 6 does not apply to the provisions of this Article. Thus, the exemption applies even to a citizen or resident of a Contracting State.

ARTICLE 22
Governmental Functions

Under this Article, wages, salaries, and similar remuneration, including pensions, annuities, or similar benefits, paid from public funds of one Contracting State to a citizen of that Contracting State, or to a citizen of a State other than a Contracting State who comes to the other Contracting State expressly for the purpose of being employed by the first-mentioned Contracting State, for labor or personal services performed as an employee of the national Government of that Contracting State, or any agency thereof, in the discharge of functions of a governmental nature will be exempt from tax by the other Contracting State. If the citizen becomes a citizen of, or acquires immigrant Status in, the other Contracting State, that other Contracting State may tax the individual without regard to this Article. See paragraphs (3) and (4)(b) of Article 6 (General Rules of Taxation).

Whether services will be treated as performed in the discharge of governmental functions may be determined by reference to the concept of a governmental function in the State in which the income arises. Thus, compensation paid in connection with industrial or commercial activity is treated the same as compensation received from a private employer. This Article applies only to remuneration paid by the national government or agencies of the national government of a Contracting State.

ARTICLE 23
Teachers

Paragraph (1) provides that, if a resident of one Contracting State is invited by the other Contracting State, a political subdivision or local authority thereof, or by a university or other recognized educational institution in that other Contracting State to come to that Contracting

State for a period not expected to exceed two years for the purpose of teaching or engaging in research, or both, at a university or other recognized educational institution, and if such resident comes to that other Contracting State primarily for such purpose, his income from personal services for teaching or research at the university or educational institution will be exempt from tax by that other Contracting State for a period not exceeding two years from the date of his arrival in that other Contracting State.

Since a temporary visit may be of such a duration that an individual may lose his status as a resident of the Contracting State of which he was a resident at the time he became eligible for the benefits of this Article, the individual need only be a resident of such Contracting State at the beginning of his visit. However, if the individual becomes a citizen of, or acquires immigrant status in, the other Contracting State, that other Contracting State may tax the individual without regard to this Article. See paragraphs (3) and (4)(b) of Article 6 (General Rules of Taxation). If the individual's visit exceeds a period of two years from the date of his arrival, the exemption applies only to the income received by the individual before the expiration of such two-year period.

Pursuant to paragraph (2), this Article does not apply to income from research undertaken not in the public interest but primarily for the private benefit of a specific person or persons other than the person performing the research.

ARTICLE 24
Students and Trainees

Paragraph (1) provides that an individual who is a resident of one Contracting state at the time he becomes temporarily present in the other Contracting State and who is temporarily present therein for the primary purpose of studying at a university or other recognized educational institution, securing training required to qualify him to practice a profession or professional specialty, or studying or doing research as a recipient of a grant, allowance, or award from a government, religious, charitable, scientific, literary, or educational organization, will be exempt from tax by that other Contracting State for a period not exceeding five taxable years from the date of his arrival in that other Contracting State on:

(1) gifts from abroad for the purpose of his maintenance, education, study, research or training;

(2) the grant, allowance, or award; and

(3) income from personal services performed in the other Contracting State not in excess of $3,000 or its equivalent in Israeli pounds for any taxable year.

Under, paragraph (2), an individual who is a resident of one Contracting State at the time he becomes temporarily present in the other Contracting State and who is temporarily present therein as an employee of, or under contract with, a resident of the first-mentioned Contracting State, for the primary purpose of acquiring technical, professional, or business experience from a person other than that resident of the first-mentioned Contracting State or other than a person related to such resident, or studying at a university or other recognized educational institution in that other Contracting State, will be exempt from tax by that other Contracting State for a period

not exceeding twelve consecutive months, on income from personal services not in excess of $7,500 or its equivalent in Israeli pounds.

Under paragraph (3), an individual who is a resident of one Contracting State at the time he becomes temporarily present in the other Contracting State and who is temporarily present therein for a period not exceeding one year, as a participant in a program sponsored by the other Contracting State, for the primary purpose of training, research, or study, will be exempt from tax by the other Contracting State with respect to his income from personal services in respect of such training, research, or study performed in that other Contracting State in an aggregate amount not in excess of $10,000 or its equivalent in Israeli pounds.

The monetary limits provided in paragraph (1), (2), or (3) are in addition to, and not in lieu of, other exemptions provided by the Code. Thus, an unmarried resident of Israel who is temporarily present in the United States for the primary purpose of studying at a university would be entitled to exclude $3,000 of income from the performance of personal services and, in addition, would be entitled to the personal exemption allowed by section 151 of the Code, as provided in section 873(b) of the Code.

The first sentence of paragraph (4) provides that the benefits provided in paragraph (1) and the benefits provided under Article 23 (Teachers), when taken together, may extend only for such period of time, not to exceed five taxable years from the date of the individual's arrival, as may reasonably or customarily be required to effectuate the purpose of the visit. The second sentence of paragraph (4) makes it clear that the benefits provided by Article 23 will not be available to an individual if, during the immediately preceding period, the individual enjoyed the benefits provided by paragraph (1). Thus, an Israeli individual who originally entered the United States for the purpose of becoming a student and received benefits under paragraph (1) must leave the United States and, if necessary, reestablish residence in Israel and then return at the invitation of the United States, a political subdivision or local authority thereof, or a university or other recognized educational institution for the primary purpose of becoming a teacher in order to take advantage of Article 23.

If an individual qualifies for the benefits of more than one of the provisions of Article 23 and this Article, such individual may choose the most favorable provision but may not claim the benefits of more than one provision in any taxable year as a means of avoiding the limitations provided. Thus, for example, an individual who comes to the other Contracting State for the primary purpose of studying may be able to qualify under either paragraphs (2) or (3) of this Article. However, he cannot combine the maximum exclusion limits in those two paragraphs to exclude $17,500 during the taxable year. If the individual becomes a citizen of, or acquires immigrant status in, the other Contracting State, that other Contracting State may tax the individual without regard to this Article. See paragraphs (3) and (4)(b) of Article 6 (General Rules of Taxation).

ARTICLE 25
Investment or Holding Companies

The Article provides that a corporation of one Contracting State deriving dividends, interest, royalties or capital gains from sources within the other Contracting State will not be entitled to the benefits of Article 12 (Dividends), 13 (Interest), 14 (Royalties), or 15 (Capital Gains) if by reason of special measures the tax imposed on such corporation by the first-mentioned Contracting State with respect to such dividends, interest, royalties or capital gains is substantially less than the tax generally imposed by such Contracting State on corporate profits, and twenty-five percent or sore of the capital of such corporation is held of record or is otherwise determined, after consultation between the competent authorities of the Contracting States to be owned, directly or indirectly, by one or more persons who are not individual residents of the first-mentioned Contracting State (or, in the case of an Israeli corporation, who are citizens of the United States). For purposes of applying this Article, it is intended that the requisite direct or indirect ownership be tested at the individual shareholder level. Existing Code provisions dealing with the taxation of capital gains do not make this Article applicable with respect to capital gains.

The purpose of this Article is to deal with potential abuse which could occur if one of the Contracting States provided preferential rates of tax for investment or holding companies. In the absence of this Article, residents of third countries could organize a corporation in the Contracting State extending the preferential rates for the purpose of making investments in the other Contracting State. The combination of low tax rates in the first Contracting State and the reduced rates or exemptions in the other Contracting State would enable the third country residents to realize unintended benefits.

ARTICLE 26
Relief from Double Taxation

In order to avoid double taxation, each Contracting State agrees in this Article to provide to its citizens or residents a credit against its taxes for taxes paid by such persons to the other Contracting State.

The United States agrees to allow a United States citizen or resident as a credit against United States tax an appropriate amount of taxes paid or accrued to Israel in accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle of paragraph (1)). In addition, in the case of a United States corporation owning at least ten percent of the voting stock of an Israeli corporation from which it receives dividends in any taxable year, the United States will allow credit for the appropriate amount of taxes paid or accrued to Israel by the Israeli corporation paying such dividends with respect to the profits out of which such dividends are paid. The appropriate amount will be based upon the amount of tax paid or accrued to Israel, but the credit is not to exceed the limitations (for the purpose of limiting the credit to the United States tax on income from sources within Israel or on income from sources outside of the United States) provided by United States law for the taxable year. This provision does not require the United States to maintain a per-country or overall limitation in the future so long as the general principle of a foreign tax credit remains in effect. For the purpose of applying the United States credit in relation to taxes paid or accrued to Israel, the rules set forth in Article 4 (Source of Income) will

be applied to determine the source of income and the taxes referred to in paragraphs (l)(b) and (2) of Article 1 (Taxes Covered) will be considered to be income taxes. Whether Israeli taxes are paid or accrued is determined under the rules of the Code. A taxpayer may, for any year, claim a foreign tax credit under the rules of the Code. In that case, he would forego the rules of the Convention that guarantee income tax status for the specified Israeli taxes.

Paragraph (2) details the treatment for United States tax purposes of compulsory loans to Israel made by United States citizens or residents or by a subsidiary of a United States corporation. If for any taxable year a United States citizen or resident takes a credit against tax for a compulsory loan to Israel (which is included as a tax under paragraph (l)(b)(v) of Article 1 (Taxes Covered)), whether paid by such citizen or resident or by a corporation 10 percent or more of the voting stock of which is owned by such citizen or resident, then any interest received on such loan is not to be included in taxable income and no deduction is to be allowed for any interest subsequently assessed or collected by the United States; upon repayment or recoupment of the principal of the loan, the amount of the value in United States dollars received shall be treated as a refund for the year the loan was made of taxes paid to Israel for such year equal to the basis for such loan, and the amount of any tax credit taken shall be recomputed, notwithstanding the operation of any law or rule of law: any such amount in excess of such basis shall be included in taxable income for the year the repayment or recoupment is made: and no interest will be assessed or collected by the United States on any amount of tax due for the year the loan vas made except to the extent that interest was received from Israel on the loan. Thus, the United States, is to permit treatment of the compulsory loan payment as a creditable tax and will be entitled to its normal interest charges to the extent made on such loan, but not to exceed the amount actually received by the taxpayer.

Where the taxpayer has previously claimed an indirect credit for a compulsory loan payment made by a subsidiary corporation, the taxpayer at the time of payment of interest by Israel to the subsidiary will be considered to be the recipient of such Interest. The amount of the interest will be considered a contribution to the capital of the subsidiary by the taxpayer. As under section 905(c) of the Code, the recomputation and payment of tax shall be made without regard to any otherwise applicable statute of limitations on assessments. The Secretary of the Treasury will prescribe regulations he deems necessary to carry out the purposes of this paragraph, including rules for determining whether an amount included as a tax under paragraph (l)(b)(v) of Article 1 (Taxes Covered) has been taken as a credit against tax.

Under paragraph (3), Israel will allow a resident of Israel as a credit against Israeli tax the appropriate amount of income taxes paid or accrued to the United States and, in the case of an Israeli corporation owning at least ten percent of the voting stock of a United States corporation from which it receives dividends in any taxable year, will also allow credit for the appropriate amount of taxes paid or accrued to the United States by the United States corporation paying such dividends with respect to the profits out of which such dividends are paid. The appropriate amount will be based upon the amount of tax paid or accrued to the United States but will not exceed that portion of Israeli tax which such residents net income from sources within the United States bears to his entire net income for the same taxable year. For the purpose of applying the Israeli credit in relation to taxes paid or accrued to the United States, the rules set forth in Article 4 (Source of Income) will be applied to determine the source of income, and the taxes referred to

in paragraphs (1)(a) and (2) of Article 1 (Taxes Covered) will be considered to be creditable taxes.

The saving clause in paragraph (3) of Article 6 (General Rules of Taxation) does not apply to this Article. Thus, the provisions of this Article may be relied upon a citizen or resident of a Contracting State.

ARTICLE 27
Nondiscrimination

Paragraph (1) provides that a citizen of one Contracting State who is a resident of the other Contracting State will not be subject in that other Contracting State to more burdensome taxes than a citizen of that other Contracting State who is a resident thereof. The determination of whether there is more burdensome taxation is to be made by comparing the treatment of individuals who are in comparable positions. Thus, for example, a citizen of Israel who is a resident of the United States and who otherwise meets the requirements specified in section 911 of the Code would, under this Article, be eligible for the benefits of section 911 even though not a citizen of the United States.

Paragraph (2) provides that a permanent establishment which a resident of one Contracting State has in the other Contracting State will not be subject in that other Contracting State to more burdensome taxes than a resident of that other Contracting State carrying on the same activities. However, this does not obligate a Contracting State to grant to individual residents of the other Contracting State any personal allowances, reliefs, or deductions for taxation purposes on account of civil status or family responsibilities which it grants to its own individual residents.

Paragraph (3) prohibits one Contracting State from subjecting a corporation of such Contracting State the capital of which is wholly or partly owed or controlled, directly or indirectly, by one or more residents of the other Contracting State to any taxation or any requirement connected with taxation which is other or more burdensome than those applicable to corporations of the first-mentioned Contracting State carrying on the same activities, the capital of which is wholly or partly owned or controlled by one or more residents of the first-mentioned Contracting State.

Under paragraph (3) of Article 1 (Taxes Covered), the provisions of this Article extend to all taxes of every kind imposed at the national level.

The provisions of this Article do not override the right of the United States to impose the tax provided in Code section 897 (relating to gains derived by nonresident aliens or foreign corporations from U.S. real property interests).

The saving clause in paragraph (3) of Article 6 (General Rules of Taxation) does not apply to this Article. Thus, a Contracting State may not deny any rights conferred by this Article to its citizens and residents.

ARTICLE 28
Mutual Agreement Procedure

Under paragraph (1), when a resident or citizen of one Contracting State considers that action of one or both Contracting States results or will result for him in taxation not in accordance with the Convention, he may, notwithstanding the remedies provided by the national laws of the Contracting States, present his case to the competent authority of the Contracting State of which he is a resident or citizen. A resident (or citizen) of a Contracting State need not, although it is anticipated that in the normal situation he will, exhaust his other administrative or judicial remedies prior to resorting to the use of the mutual agreement procedure. If the claim is considered to have merit by the competent authority, that competent authority will endeavor to come to an agreement with the competent authority of the other Contracting State with a view to the avoidance of taxation not in accordance with the Convention.

Paragraph (2) requires the competent authorities of the two Contracting States to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the application of the Convention. In particular, the competent authorities may agree to the same attribution of industrial or commercial profits to a resident of one Contracting State and its permanent establishment situated in the other Contracting State; the same allocation of income, deductions, credits, or allowances between a resident of one Contracting State and a related person and to the readjustment of taxes imposed by each Contracting State to reflect such allocation; the same determination of the source of particular items of income; the same characterization of particular items of income; and the mode of application of Articles 15-A (Charitable Contributions) and 29 (Exchange of Information). The list of subjects of potential mutual agreement in paragraph (2) is not exhaustive; it merely illustrates the principles set forth in the paragraph.

Under paragraph (3), in implementing the provisions of this Article, the competent authorities may communicate with each other directly and, when advisable, meet together for an oral exchange of opinions.

Under paragraph (4), in cases in which the competent authorities reach an agreement, taxes will be imposed on such income, and refund or credit of taxes allowed, by the Contracting States in accordance with such agreement. This permits the issuance of a refund or credit notwithstanding procedural barriers otherwise existing under a Contracting States law, such as the statute of limitations. However, it does not authorize additional taxes to be imposed after the statute of limitations has run.

ARTICLE 29
Exchange of Information

Paragraph (1) provides for a system of administrative cooperation between the competent authorities of the two Contracting States by requiring an exchange of information pertinent to carrying out the provisions of the Convention or preventing fraud or fiscal evasion in relation to

the taxes which are the subject of the Convention. The competent authorities may exchange information in connection with tax compliance generally, not merely illegal acts or crimes. Information exchanged must be treated as secret and cannot be disclosed to any persons or authorities other than those concerned with the assessment, including judicial determination, or collection of the taxes which are the subject of the Convention. Thus, disclosure is not prohibited as a part of a public proceeding before a court or administrative body.

Paragraph (2) makes clear that a Contracting State is not obligated to carry out administrative measures at variance with the laws or the administrative practice of either Contracting State; to supply particulars which are not obtainable under the laws or in the normal course of the administration of either Contracting State; or to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information the disclosure of which would be contrary to public policy.

In making the determinations necessary under paragraph (2) a Contracting State will use the standards it uses in the enforcement of its own laws by its administrative and judicial authorities, treating the tax of the Contracting State with respect to which a request relates as if it were a tax of the Contracting State requested to furnish the information and were being imposed by such Contracting State. Depositions of witnesses and copies of unedited original documents (including books, papers, statements, records, accounts, or writings) may be provided by the competent authority of a Contracting State if specifically requested by the competent authority of the other Contracting State. In addition, any information which may be furnished in accordance with this Article should not be withheld by reason of any doctrine of law under which international judicial assistance is not accorded in tax matters.

The exchange of information may be on either a routine basis or on request with reference to particular cases. The competent authorities may agree on the list of information to be furnished on a routine basis.

In an exchange of notes signed at the time of the signing of the Protocol, Israel noted that at the present time, its manpower resources and technical capabilities do not permit it to provide information on a routine basis with respect to U.S. residents receiving dividends, interest, and royalties from Israel, nor is it in a position to provide information not already existing in the Finance Minister’s files. The Government of Israel, however, does intend to remedy its manpower and technical deficiencies so that it will be able to exchange the full range of information provided for in the Convention.

ARTICLE 30
Diplomatic and Consular Officers

This Article provides that nothing in the Convention will affect the fiscal privileges of diplomatic and consular officials under the general rules of international law or under the provisions of special agreements.

ARTICLE 31
Entry into Force

This Article and Article XVI of the Protocol provide that the Convention and the Protocol are subject to ratification and provide for the exchange of instruments of ratification. The Convention and Protocol will enter into force thirty days after the date of exchange of such instruments of ratification. The Convention shall first have effect as respects the rate of withholding of tax, to amounts paid on or after the first day of the second month following the date on which the Convention enters into force, and, as respects other taxes, to taxable years beginning on or after January 1 of the year following the date on which the Convention enters into force.

ARTICLE 32
Termination

Paragraph (1) provides that the Convention will continue in force indefinitely, but that it may be terminated by either Contracting State at any time after five years from the date it enters into force. A Contracting State seeking to terminate the Convention must give at least six months' notice through diplomatic channels. If the Convention is terminated, such termination will be effective with respect to income of calendar years or taxable years beginning (or in the case of taxes payable at source, payments made) on or after April 1 next following the expiration of the six month period. It is intended that the reference to calendar years applies only to cases where the taxable year is the calendar year.

Under paragraph (2), the provisions of Article 21 (Social Security Payments) may be terminated by either Contracting State at any time after the Convention enters into force by prior notice given through diplomatic channels.

EXCHANGES 0F NOTES (PROTOCOL 1)

Three notes were exchanged at the time of the signing of the Protocol. A note dealing with exchanges of information is described in the explanation of Article 29 (Exchange of Information). A note dealing with procedures for certifying organizations in the Contracting State as eligible to receive deductible contributions is described in the explanation of Article 15-A (Charitable Contributions). The third note observed that during the negotiations, the Israeli delegation had stressed the need for provisions in the Convention, such as an investment credit, which would promote the flow of United States investment to Israel. While observing that the United States cannot, at the present time, agree to such a provision, the United States offered assurances that, should circumstances change, including the manner in which the United States taxes income from investments in Israel, the U.S. would be prepared to resume discussions with a view to incorporating provisions into the Convention which will minimize the interference of the United States tax system with incentives offered by Israel. These provisions would be consistent with United States tax policies regarding other developing countries.

PROTOCOL 2

UNITED STATES TREASURY DEPARTMENT'S TECHNICAL EXPLANATION OF THE SECOND PROTOCOL AMENDING THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF THE STATE OF ISRAEL WITH RESPECT TO TAXES ON INCOME SIGNED ON JANUARY 24, 1993

The Second Protocol ("the Protocol") signed at Jerusalem on January 26, 1993, amends the Convention Between the Government of the United States of America and the Government of the State of Israel with respect to Taxes on Income, signed on November 20, 1975, as amended by the Protocol signed On May 30, 1980, ("the Convention"). This technical explanation is an official guide to the Protocol. It reflects policies behind particular provisions, as well as understandings reached with respect to the interpretation and application of the Protocol. The technical explanation is not intended to provide a complete comparison between the Protocol and the Articles of the Convention that it amends.

The Protocol was accompanied by notes, signed at the time of the signature of the Protocol (the "Exchange of Notes"), indicating the views of the negotiators and the Contracting States with respect to a number of the provisions of the Protocol. In the discussions of each of the Articles of the Protocol in this explanation, the relevant portions of the Exchange of Notes also are discussed.

ARTICLE I

Article I of the Protocol amends Article 1 (Taxes Covered) of the Convention. Paragraph 1 of Article I of the Protocol amends subparagraph (a) of paragraph (1) of Article 1 of the Convention in two respects. In referring to the U.S. Internal Revenue Code ("Code"), it replaces the words "Internal Revenue Code" with the words "Internal Revenue Code of 1986". This change reflects the fact that the Tax Reform Act of 1986 ("TRA") was enacted after the date of signature of the Convention. The Convention covers both existing taxes, and taxes substantially similar to those existing taxes that are enacted after the date of signature of the Convention. The TRA introduced certain taxes into the Code that, arguably, arm not substantially similar to those in the pre-1986 Code (e.g., branch profits tax and gross basis tax on shipping profits). In order to make certain that these taxes are covered by the Convention as amended by the Protocol, subparagraph (a) of paragraph (1) is changed to clarify that the base against which any new taxes are judged is the Internal Revenue Code of 1986.

The second change in subparagraph (a) is the addition of the words "but excluding social security taxes" to the description of the U.S. taxes covered. This change, introduced at Israel's request, conforms the Convention to U.S. policy, which is not to cover social security taxes in t3x treaties, but to reserve coverage of those taxes to social security Totalization agreements.

There is no such agreement in force between the United States and Israel. Because of the exclusion of social security taxes, for example, if an Israeli resident earns personal service income during a temporary visit to the United States, and his remuneration is exempt from U.S. income tax under one of the personal services provisions of the Convention, whether he will be subject to social security taxes will be determined, independent of the Convention, under the rules of U.S. law. The exclusion of social security taxes from the coverage of the Convention does not affect the taxation of social security benefits, which are dealt with in Article 21 (Social Security Payments) of the Convention.

Paragraph 2 of Article I of the Protocol modifies the description of the Israeli taxes covered for purposes of the Convention. The changes conform the coverage under the Convention to current Israeli law. After the Protocol's amendments, the income taxes covered in the case of Israel are the taxes imposed by the Israeli Income Tax Ordinance, by the Land Appreciation Tax Law, by the Income Tax Law (Adjustments for Inflation), and other taxes on income administered by the Government of Israel. This latter category is defined to include, but is not limited to, the profit tax on barking institutions and insurance companies, and the income tax component of a compulsory loan. Paragraph 1 of the Exchange of Notes clarifies that “other taxes on income administered by the Government of Israel” includes only taxes that are imposed solely under Israeli law.

Paragraph 3 of Article I of the Protocol replaces paragraph (3) of Article 1 of the Convention. This paragraph defines the tax coverage of the Convention for purposes of Article 27 (Nondiscrimination). Under the Protocol, in conformity with standard U.S. treaty policy, the nondiscrimination protection of the Convention will apply to all taxes imposed at all levels of Government -- by the Contracting States, or by a state or political subdivision of a state. Paragraph 2 of the Exchange of Notes confirms that the coverage includes taxes imposed by local authorities.

ARTICLE II

Article II of the Protocol amends Article 3 (Fiscal Residence) of the Convention. Paragraph 1 of Article II of the Protocol adds a new subparagraph (c) to paragraph (1) of Article 3, clarifying the circumstances under which a U.S. citizen or "green card" holder is to be treated, for purposes of the Convention, as a U.S. resident. The new subparagraph (c) provides that a U.S. citizen or green card holder, who is not, under the provisions of this Article, a resident of Israel, 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. If such a person is a resident both of the United States and of Israel, whether he is to be treated as a resident of the United States or Israel 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 Israel, but has ties to a third State, in the absence of subparagraph (c), 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. 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,

under this rule, be entitled to Israeli benefits under the Convention. 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 under this rule.

Paragraph 3 of the Exchange of Notes clarifies the meaning of the term "a person resident in Israel", as the term is used in subparagraph (a)(ii) of paragraph (1) of Article 3 (Fiscal Residence) of the Convention. The term is understood to refer to persons on whom taxes are imposed by Israel pursuant to the Income Tax Ordinance on income from sources outside Israel by virtue of their being Israeli citizens.

Paragraph 2 of Article II of the Protocol amends subparagraph (a) of paragraph (2) of Article 3 of the Convention to correct a cross-reference to a section of the Israeli Income Tax Ordinance that had changed from section 9(16) to section 35 between the time of the signing of the Convention and the negotiation of the Protocol.

Paragraph 3 of Article II of the Protocol amends paragraph (3) of Article 3 of the Convention. The paragraph defines the extent to which dual residents, other than individuals, are to be treated as resident in one of the Contracting States for purposes of the Convention. Under the Convention, the provision applies to dual resident corporations. The Protocol broadens to coverage to all non-individual dual residents. A corporation is resident in the United States if it is created or organized under the laws of the United States or a political subdivision. Under Israeli law a corporation is treated as a resident of Israel if it is either established there or managed and controlled there. Dual corporate residence, therefore, can arise if a U.S. corporation is managed in Israel. Under paragraph (3), the competent authorities are first to seek to settle the question of that person's residence by mutual agreement, and determine how the Convention is to apply to that person. Unless or until the competent authorities make such a determination, however, the person is not to be treated as a resident of either Contacting State, except for purposes of certain specified Articles. Such persons may claim the benefits of the foreign tax credit under Article 26 (Relief from Double Taxation), and of protection against discrimination under Article 27 (Nondiscrimination). Thus, a dual-resident corporation may claim double taxation relief in one or both of the Contracting States that tax its worldwide income, and neither Contracting State can discriminate against a duel-resident corporation.

Since it is only for the purposes of deriving treaty benefits that such non-individual dual residents are excluded from the Convention, they may be treated as resident for other purposes, such as for determining whether treaty benefits should attach to payments made by such persons. For example, if a dual-resident corporation pays a dividend to a resident of Israel, 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 Israel, 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. Paragraph 3, therefore, provides that a non-individual dual resident shall be treated as a resident for purposes of payments of dividends, interest, and royalties by such persons, under paragraph 2 of Article 12 (Dividends), paragraphs (2) and (3) of Article 13 (Interest), and paragraph (l)(b) of a 14 (Royalties). Since information exchange under Article 29 (Exchange of Information and Administrative Assistance) is not

limited to residents of the Contracting States, information can be exchanged about dual residents. To the extent that the Convention is relevant for dual-residents it must enter into force for such purposes. Therefore, Article 31 (Entry Into Force) also applies to dual-resident corporations.

Paragraph 4 of the Exchange of Notes applies to paragraph (3) of Article 3. It clarifies the fact that when one of the provisions of the Convention applies to a dual resident, any other provision necessary to give effect to that provision will also apply. For example, as noted above, a dividend paid by a dual-resident corporation to a resident of one of the Contracting States is entitled to the benefit of the reduced rate of tax at source. The source rule in paragraph (1) of Article 4 (Source of Income) will apply to determine the source of a dividend for this purpose, even though Article 4 is not specified in paragraph (3) of Article 3 (Fiscal Residence).

ARTICLE III

Article III of the Protocol amends two of the source rules in Article 4 (Source of Income) of the Convention. Both changes are technical changes necessary to conform the source rules to the substantive taxing rules of the Convention as they are amended by the Protocol. Paragraph 1 of Article III amends the source rule for gain from the sale or exchange of personal property to make the source rule for gain on the disposition of corporate shares reciprocal. This change conforms the source rule to the rule in Article 15 (Capital Gains) for the taxation of gain on the disposition of corporate shares, which is amended by Article X of the Protocol to make it apply reciprocally. As provided in paragraph 3 of Article XIII of the Protocol, this source rule applies notwithstanding the saving clause of paragraph (3) of Article 6 (General Rules of Taxation).

Paragraph 5 of the Exchange of Notes relates to paragraph 1 of Article III of the Protocol. It notes that, in applying the rules of the Convention to gain received by a U.S. resident on the disposition of shares in an Israeli corporation, section 865(h) of the Code say be applied to limit the foreign tax credit allowed to the U.S. resident on a per-item of income basis.

Paragraph 2 of Article III of the Protocol amends paragraph (7) of Article 4 of the Convention to conform the language of the source rule for Government remuneration, dealt with in Articles 21 (Social Security Payments) and 22 (Governmental Functions), to the broadened definition of the term "public funds of one of the Contracting States" in Article 22, resulting from Article XI of the Protocol.

ARTICLE XV

Article IV of the Protocol amends paragraph (5) of Article 5 (Permanent Establishment) of the Convention to conform the rule of the paragraph to that reflected in the current U.S., U.N. and OECD Model Conventions. As amended by the Protocol, paragraph (5) provides that a dependent agent of a resident of a Contracting State will constitute a permanent establishment in the other Contracting State if the agent has, and habitually exercises in the other State, the authority to conclude contracts in the name of the resident, unless his activities are of the type that would not give rise to a permanent establishment under the provisions of paragraph (3) of

Article 5.

ARTICLE V

Article V of the Protocol amends Article 6 (General Rules of Taxation) of the Convention in several respects. Paragraph 1 of Article V of the Protocol conforms the rule of paragraph (3) of Article 6 to current U.S. treaty policy regarding the treatment of former U.S. citizens. It provides that, for purposes of the saving clause in paragraph (3), a citizen of a Contracting State includes a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of tax. Such a former citizen is to be treated as a citizen for this purpose only for £ period of 10 years following the loss of citizenship. In the United States, 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. The paragraph also provides for consultation by the competent authorities on the purposes of an individual's loss of citizenship.

Paragraph 2 of Article V of the Protocol amends subparagraph (a) of paragraph (4) of Article 6 of the Convention, which contains exceptions to the saving clause. The source State's exemptions of alimony and annuities, and the residence State exemption for child-support payments, in paragraph (2) and (3), respectively, of Article 20 (Private Pensions and Annuities), are added to the general exceptions to the saving clause.

Paragraph 3 of Article V of the Protocol amends paragraph (6) of Article 6 (General Rules of Taxation) of the Convention. Paragraph (6) contains a so-called "remittance basis" rule, under which source-country relief under the Convention applies only to that portion of an item of income that is remitted to the residence country, if the rule in the residence country is to subject to tax only the remitted income. Under the Convention the income must be remitted during the year in which the income accrues. The protocol modifies this rule to allow source relief if the income is remitted during the year of accrual or during the first three months of the following year. This amendment permits relief from source-country tax even in cases where there is a short time leg between the time of accrual of the income and the time it is remitted that may extend into the next taxation year.

Paragraph 4 of Article V of the Protocol adds two new paragraphs to Article 6 (General Rules of Taxation) of the Convention. The new paragraphs are designated as paragraphs (7) and (8), and the existing paragraph (7) becomes paragraph (9).

The new paragraph (7) elaborates on paragraph (8) of Article 4 (Source of Income), paragraphs (1) and (2) of Article 8 (Business Profits), paragraph (5) of Article 12 (Dividends), paragraph (5) of Article 13 (Interest), paragraph (3) of Article 14 (Royalties), and subparagraph (c) of paragraph (1) of Article 15 (Capital Gains). This paragraph incorporates the principle of Code section 864(c)(6) into the Convention. Like the Code section on which it is based, the new paragraph (7) provides that any income or gain attributable to a permanent establishment (or, in the context of Articles 12, 13 and 14, 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 new paragraph (8) is intended to deal with changes in law or in treaty policy of either of the Contracting States, that have the effect of changing the application of the Convention in a significant manner or that alter the relationship between the Contracting States. Paragraphs 6 and 7 of the Exchange of Notes elaborate the procedure established in paragraph (8) of the Article. Paragraph (8) provides, first, that, in response to a change in the law or policy of either State, the appropriate authority of either State may request consultations with its counterpart in the other State to determine whether a change in the Convention is appropriate. The "appropriate authorities" may be the Contracting States themselves, communicating through diplomatic channels, or they may be the competent authorities under the Convention, communicating directly. The request for consultations may come either from the authority of the Contracting State making the change in law or policy, or it may come from the authority of the other State. If the authorities determine, on the basis of the consultations, that a change in domestic legislation has significantly altered the balance of benefits provided by the Convention, they will endeavor, promptly, to amend the Convention to restore an appropriate balance. The authorities also may consult regarding a change in treaty policy or domestic law by one of the Contracting States. The purpose of these consultations would be to determine whether the change in policy should result in amendment of the Convention.

Paragraph 7 of the Exchange of Notes provides several examples of the kinds of unilateral changes that may prompt a decision to seek to negotiate amendments to the Convention. Such a decision may result from the granting by one of the Contracting States of favorable benefits to a third country, such as an agreement to Liberalize the foreign tax credit granted by treaty. Another example provided in the Exchange of Notes is the granting to a third-country partner of corporate/shareholder integration benefits. Paragraph 7 of the Exchange of Notes also suggests that, as long as the U.S.-Israel Free Trade Agreement remains in force, if one Contracting State treats expenses, for example research and development expenses, incurred within that State more favorably than the same expenses incurred within the other State, such a change would lead to consultations regarding possible amendments to the Convention.

Paragraph 6 of the Exchange of Notes states the agreement of the Contracting States that if the United States grants tax sparing credits under agreement with any other country, the Convention will be amended promptly to incorporate such a provision.

ARTICLE VI

Article VI of the Protocol amends Article 7 (Income from Real Property) by replacing the text of paragraph (3) with a new text. The paragraph deals with the taxation of gain attributable to the alienation of real property. Gain from the alienation of the real property itself is dealt with in paragraph (1) of Article 7. Under paragraph (3), the Contracting State in which the underlying real property is located may tax the gain. The purpose of the change in paragraph (3) is to cover the full range of gains attributable to real property that may be taxed by the United States under the FIRPTA provisions in section 897 of the Code.

Subparagraph (a) of paragraph (3) of Article 7 provides that the United States may tax a

resident of Israel on gain from the alienation of a U.S. real property interest, or from the alienation of an interest in a partnership, trust or estate, to the extent attributable to a United States real property interest. The term "U.S. real property interest" is understood to have the same meaning as the term has in section 897 of the Code. Thus, an Israeli resident would be subject to U.S. tax on gain from the alienation of shares in a U.S. corporation, the property of which consists principally of U.S.-situs real property. Similarly, an Israeli resident would be subject to tax on a liquidating distribution by such a U.S. corporation and on a distribution by a Real Estate Investment Trust ("REIT") attributable to gain from the alienation of U.S. -situs real property. This provision also preserves the U.S. right to tax gain from the alienation of an int5re5t in a partnership, trust or estate, to the extent that the gain is attributable to U.S.-situs real property. Subparagraph (b) makes the provision reciprocal, and provides that Israel may tax a U.S. resident on gain from the alienation of comparable interests in Israeli real property.

ARTICLE VII

Article VII of the Protocol amends Article 12 (Dividends) of the Convention. Paragraph 1 of Article VII of the Protocol makes a technical, clarifying amendment to subparagraph (b) of paragraph (2) of Article 12. Subparagraph (b) provides for reduced rates of tax at source for intercorporate dividends under certain circumstances. The amendment clarifies that the rules in the subparagraph apply to dividends paid both by U.S. and Israeli corporations.

Paragraph 2 of Article VII of the Protocol introduces a new paragraph (3) to Article 12 of the Convention, and renumbers the previous paragraphs (3) and (4) of the Convention as paragraphs (4) and (5) respectively. The new paragraph (3) deals with dividends paid by U.S. entities that are Regulated Investment Companies ("RICs") and REITs (subparagraph (a)), and by equivalent conduit organizations in Israel (subparagraph (b)). Dividends paid by RICs are denied the 12.5 percent direct dividend rate and subjected to the 25 percent portfolio dividend rate regardless of the percentage of voting shares held directly by a corporate recipient of the dividend. A dividend paid by a RElT will be taxed in the United States at full statutory rates (30 percent), unless the beneficial owner of the dividend is an individual resident of Israel who owns less that a 10 percent interest in the RElT, in which case he will be taxed at the portfolio dividend withholding rate of 25 percent.

The denial of the 12.5 percent withholding rate at source to all RIC and RElT shareholders, and the denial of the 25 percent rate to most shareholders of REITs is intended to prevent the use of these conduit entities to gain unjustifiable benefits for certain shareholders. For example, an Israeli corporation that wishes to hold a diversified portfolio of U.S. corporate shares may hold the portfolio directly and pay a U.S. withholding tax of 25 percent on all of the dividends that it receives. Alternatively, it may place the portfolio of U.S. stocks in a RIC, in which the Israeli corporation owns most of the shares, but in which the corporation has arranged to have a sufficient number of small shareholders to satisfy the RIC diversified ownership requirements. Since a RIC generally pays no corporate-level U.S. income tax there is no U.S. tax cost to the Israeli corporation of interposing the RIC as an intermediary in the chain of ownership. That interposition has, however, absent the special rule in paragraph (3), served to transform portfolio dividends, taxable in the United States under the Convention at 25 percent

into direct investment dividends, taxable at only 12.5 percent.

Similarly, a resident of Israel may hold U.S. real property directly, and pay U.S. tax either at a 30 percent rate on the gross income or, generally, at a 31 or 35 percent on the net income. As in the preceding example, by placing the real estate holding in a REIT, the Israeli investor can transform real estate income into dividend income, and in the process, absent the special rule, transform, at no tax cost, high-taxed income into lower-taxed income. In the absence of the special rule, if the RElT shareholder is an Israeli corporation that owns at least a 10 percent interest in the REIT, the withholding rate would be 12.5 percent; in all other cases it would be 25 percent. In either event, with one exception, a tax of at least 30 percent would be significantly reduced. The exception is the relatively small individual Israeli investor who might be subject to a U.S. tax of 15 percent of the net income even if he earned the real estate income directly. Under the rule in subparagraph (a), such individuals, defined as those holding less than a 10-percent interest in the REIT, remain taxable at source at a 25-percent portfolio dividends withholding rate.

Subparagraph (b) of paragraph (3) provides analogous rules for dividends paid by certain Israeli corporations. Under that new subparagraph, the reduced rates of tax at source on dividends provided in paragraph (2) do not apply to dividends paid by certain Israeli corporations that are taxed in a ·pass-through" manner. The income of these corporations is taxed in the manner described in Sections 64 and 64A of the Israeli Income Tax Ordinance. Paragraph 9 of the Exchange of Notes explains that there are several types of “pass-through”corporations that meet the standard of subparagraph (b). The corporation may be exempt from tax; the shareholders may be subject to tax on their pro-rata shares of the corporation's income; or the corporation say deduct its dividends paid from its taxable income. In cases covered by this subparagraph, the income is treated as if it were business profits from a permanent establishment, taxable according to the rules of Article 8 (Business Profits).

ARTICLE VIII

Article VIII of the Protocol amends Article 13 (Interest) of the Convention. Paragraph 1 of Article VIII adds a new subparagraph (b) to paragraph (2) of Article 13, designating paragraph (2), as it appeared in the Convention, as subparagraph (a) of paragraph (2). Subparagraph (b) provides an alternative rule for the taxation of interest at source. Subparagraph (a) provides for withholding at source at either a 17.5 or 10 percent rate, the latter applying to interest on loans made by financial institutions. The gross-basis withholding tax of subparagraph (a) will not apply if, under subparagraph (b), the interest recipient elects to be taxed by the source State on its net interest income, under-the rules of Article S (Business Profits), as though the interest income were industrial and commercial profits, attributable to a permanent establishment in the source State. The paragraph further provides for the adoption by each competent authority of rules far determining and reporting taxable income under this provision. Each competent authority also may adopt procedures requiring the provision by the taxpayer of adequate books and records for determining the proper amount of net income. The U.S. competent authority will provide rules for the apportionment of expenses, as would be required under Article 8, in determining net income for purposes of U.S. source basis tax.

Paragraph 2 of Article VIII of the Protocol adds a new paragraph (8) to Article 13 (Interest). Paragraph (8) provides that the reductions in tax at source for interest provided for in paragraph (2), and the exemption at source provided for in paragraph (3), do not apply to an excess inclusion with respect to a residual interest in a U.S. real estate mortgage investment conduit (REMIC). This class of income, therefore, will remain subject to the statutory 30-percent U.S. rate of tax at source under paragraph 1. This provision is consistent with the policy of sections 860E(e) and 860G(b) that excess inclusions with respect to a real estate mortgage investment conduit (REMIC) should bear full U.S. tax in all cases. Without a full tax at source foreign purchasers of residual interests would have a competitive advantage over U.S. purchasers when these interests are initially offered for sale. Also, absent this rule the U.S. FISC would suffer a revenue loss with respect to mortgages held in a REMIC because of opportunities for tax avoidance created by differences in the timing of taxable and economic income produced by these interests.

Paragraph 10 of the Exchange of Notes relates to paragraph (8) of Article 13 (Interest). It reflects the understanding that paragraph (8) was added at the request of the United States to address a problem of domestic tax avoidance arising under U.S. internal law, and notes that the United States intends to include similar provisions in all of its future treaties. The Exchange of Notes also acknowledges that the United States possibly could revise its internal laws in the future to address this problem in a manner other than by imposing tax on the recipient of the excess inclusion so that an excess inclusion under the revised laws would be treated as ordinary interest income in the hands of nonresident recipients and would be eligible for the exemptions from tax applicable to interest income under the lads of the United States. In that case such exemption would, notwithstanding paragraph (8), apply to an Israeli recipient of an excess inclusion. It is further noted that if the United States fails to include a provision similar to paragraph (8) of Article 13 in any tax treaty signed subsequent to the entry into force of this Convention, without having revised its internal laws in the manner suggested in the preceding sentence, such a change in U.S. treaty policy would make it appropriate to amend the Convention on this matter, pursuant to paragraph (8) of Article 6 of the Convention.

ARTICLE IX

Article IX of the Protocol adds a new Article 14A (Branch Tax) to the Convention. Article 14A provides for the imposition by the United States of a branch tax, both on the "dividend equivalent amount" and on "excess interest", and the imposition by Israel of a comparable tax should Israeli law be amended in the future to impose such a tax. Paragraph (1) of Article 14 confirms the right of each of the Contracting States to impose on a resident of the other, a tax in addition to the tax allowable under the other provisions of the Convention.

The bases of the U.S. taxes are described in subparagraph (a) of paragraph 2. The "dividend equivalent amount" is described in sub-subparagraph (i) and the excess interest that is subject to U.S. tax is described in sub-subparagraph (ii). The Convention does not define the term "dividend equivalent amount". It is, therefore, understood to have the same meaning as in section 884(b) of the Code and the regulations thereunder. Generally the dividend equivalent

amount is the earnings and profits of the foreign corporation (i.e., the profits of the corporation after certain adjustments including a reduction for U.S. corporate income tax) that are effectively connected with the conduct of its trade or business in the United States, decreased by any increase during the taxable year in the corporation's U.S. assets less liabilities ("U.S. net equity") or increased by any decrease in its U.S. net equity. Under the Convention the dividend equivalent amount 15 subject to U.S. tax only to the extent it is attributable to a U.S. permanent establishment.

Under the Convention, the dividend equivalent amount for any year approximates the dividend that a U.S. branch office would have paid its home office during the year if the branch had been operated as a separate U.S. subsidiary company. The dividend equivalent amount is determined taking into account not only effectively connected earnings and profits (or profits that are deemed to be effectively connected) that are attributable to a permanent establishment in the United States but also most profits from the disposition or operation of real estate that are subject to net basis income taxation in the United States under Article 7 (Income From Real Property)) or Article 15 (Capital Gains). Thus, the United States may impose its branch profits tax on the earnings and profits of an Israeli corporation attributable to a permanent establishment in the United States and on the earnings and profits that, in accordance with the Convention, are subject to taxation under U.S. internal law on a net basis either because the Israeli 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 income is gain that is taxable on a net basis, e.g., because it is attributable to the disposition of a United States Real Property Interest (other than an interest in a United States Real Property Holding Corporation).

Subparagraph (ii) of subparagraph (a) provides for the imposition of the U.S. tax on excess interest. Under section 884(f)(l)(B) of the Code, excess interest is the excess of the total amount allowable as a deduction in computing the U.S. effectively connected income of a foreign corporation over the total interest paid by the foreign corporation's U.S. trade or business. Under the Convention, the tax on excess interest applies only to the excess of interest that is deductible in computing

(i) the U.S. tax on income attributable to a permanent establishment of an Israeli corporation in the United States and

(ii) the U.S. tax on income or gain from real property (although not including, under current U.S. law, gain on shares in a United States Real Property Holding Corporation)

over the interest paid by the foreign corporation's U.S. permanent establishment.

Israel does not impose a comparable tax on a dividend equivalent amount or on excess interest under current law. Subparagraph (b) of paragraph (2), however, permits Israel to impose a tax comparable to the U.S. tax described in paragraph (a) should Israeli law, in the future, be amended to provide such a tax. The permitted Israeli tax could be imposed on an Israeli branch of a U.S. Corporation such that the branch would be taxed in a manner comparable to a similarly situated Israeli subsidiary and its U.S. parent corporation. The language of the Article permits the tax to be imposed on an Israeli branch, rather than a permanent establishment, because Israel was reluctant to limit its future flexibility in designing a tax. However, as explained in paragraph 11 of the Exchange of Notes, Israel has agreed that, if Israel should, at some time in the future,

impose a tax under subparagraph (b) of this Article in circumstances where the United States would not impose a tax under subparagraph (a), the competent authorities will consult with a view to conforming the two countries' rules under the Convention. Paragraph 11 of the Exchange of Notes states a further understanding that if a resident of a Contracting State qualifies for benefits under the Convention (i.e., the resident satisfies one or more of the tests of Article 25 (Limitation on Benefits)) that person will not be subject to the branch tax imposed by the other Contracting State, except as provided in the Convention. This merely confirms to Israel the result under U.S. law that the "qualified residence" rules of Code section 884(e)(4) do not override the Limitation on Benefits rules of the Convention to deny branch tax benefits to a resident of Israel in circumstances where Convention's benefits would have been allowed under Article 25.

Paragraph (3) specifies the rates at which the taxes described in paragraph (2) may be imposed. Under subparagraph (a), the rate applicable in the United States to the tax on dividend equivalent amount may not exceed 12.5 percent. This is the general rate provided for in paragraph (2) of Article 12 (Dividends) applicable to direct investment dividends. Under subparagraph (b), the maximum rate of U.S. tax on excess interest is 5 percent. The rate should approximate the rate at which interest derived by a resident of Israel from U.S. sources is taxed by the United States. The 5 percent rate in subparagraph (b) represents a "blended rate", reflecting the fact that under Article 13 (Interest) subject to source country tax at a variety of rates varying from zero to 17.5 percent on gross interest, or at regular graduated rates on interest less expenses. Subparagraph (c) provides that, in the event that Israel imposes a tax of the type dealt with in Article 14A, the rate will not exceed the rate applicable in the United States under subparagraphs (a) and (b) on analogous classes of income.

ARTICLE X

Article X of the Protocol makes two amendments to Article 15 (Capital Gains) of the Convention, which provides that gain derived by a resident of a Contracting State from the sale, exchange or other disposition of a capital asset shall be exempt from tax in the other Contracting State, except in certain enumerated cases.

Paragraph 1 of Article X of the Protocol amends subparagraph (a) of paragraph (1) of Article 15 of the Convention which cross refers to Article 7 (Income from Real Property) in order to better describe the rights of the situs state to tax gain attributable to real property under that Article. The amendment is necessary in light of the clarifying changes to Article 7 made by Article VI of the protocol.

Paragraph 2 of Article X of the protocol amends subparagraph (e) of paragraph (1) of Article 15 of the Convention in order to modify the cases in which Israel may tax gain derived by a U.S. resident from the sale, exchange or other disposition of shares in an Israeli corporation. Although the subparagraph is worded reciprocally, it does not provide any additional taxing rights to the United States. Under the Code the only gain (other than gain that is effectively connected with a U.S. trade or business) from the disposition of shares in a U.S. corporation by a nonresident alien or foreign corporation that the United States taxes is gain from the disposition of shares in a United States Real property Holding Corporation, and that taxing right is granted

by Article 7 of the Convention.

Under subparagraph (e) of paragraph (1) of Article 15 of the Convention as amended by the protocol, Israel may tax a U.S. resident on gain from the disposition of shares in an Israeli corporation provided the U.S. resident owned, either directly or indirectly, at any time during the 12-month period prior to the sale, shares possessing at least 10 percent of the voting power of the corporation. This gain is treated as foreign source income for purposes of determining the limitation on the U.S. foreign tax credit under Article 4 (Source of Income) as amended by Article II of the Protocol and Article 26 (Relief From Double taxation) as amended by Article XIII of the protocol. Prior to amendment by the protocol, the required ownership threshold was higher (more than 50 percent of the corporation's voting power during the 12-month period prior to the sale) and there also was a requirement that a substantial portion of the corporation's assets was used to carry on business in Israel for the three taxable years prior to the disposition.

Paragraph 3 of Article X of the protocol adds a new paragraph (2) to Article 15 which limits the gain that Israel may tax under subparagraph (e) of paragraph (1) to the amount of boot received in an otherwise tax-free reorganization of a U.S. affiliated group. In order for the provision to apply three conditions must be satisfied. First, the transferor and the transferee must be resident in the same Contracting State (the United States). Second, the transferor and the transferee must own directly or indirectly 80 percent or more of the voting rights and value of the other, or a company resident in the same Contracting State as the transferor and the transferee must own directly, or indirectly through companies resident in the same Contracting State, 80 percent or more of the vote and value of the transferor and transferee. (This condition would be satisfied by a U.S. affiliated group.) Finally, the transferee's basis, for purposes of determining gain or loss in the State in which it is resident, must be determined, in whole or in part, by reference to the transferor's basis (i.e., the transaction must be a tax-free reorganization under Section 368 of the Code so that the transferee's basis is determined under section 362(b) of the Code.

If these three conditions are satisfied then the gain that Israel may tax under subparagraph (e) is limited to the amount of cash or other property received by the transferor, which is the Same as the amount of gain that would be recognized under section 356(a) of the Code and taxed by the United States. In the event a larger amount of gain may be taxed in the transferor's State of residence, then the other Contracting State may tax the gain in accordance with its domestic law (applied consistently with the Convention). However, if the carryover-basis rule of section 362(b) of the Code applies to a transaction then the Limitation of section 356(a) of the Code must also apply, so that this is not a possibility under U.S. law at this time.

ARTICLE XI

Article XI of the Protocol amends Article 22 (Governmental Functions) of the Convention. The Protocol adds two new paragraphs to the Article that expand the scope of "public funds of a Contracting State" and "employment by a Contracting State" to cover more than the Contracting States themselves. Paragraphs (2) and (3) expand these terms to mean public funds of, and employment by,

(i) a Contracting State or a political subdivision or local authority thereof;

(ii) a corporation that is wholly owned by a Contracting State or a political subdivision or local authority thereof, provided the corporation performs functions of a governmental nature; and

(iii) a body that is treated for tax purposes the same as a Contracting State or a political subdivision or local authority thereof and that performs functions of a Governmental nature.

ARTICLE XII

Article XII of the Protocol replaces Article 25 (Investment or Holding Companies) of the Convention with a new Article 25 (Limitation on Benefits). Article 25 ensures 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 that have a substantial nexus with that 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 25, the entity would generally be entitled to benefits as a resident of a Contracting State, subject, to any limitations imposed by the domestic law of the source State, (e.g., business purpose, substance-over-form, step transaction or conduit principles)

Paragraph 1 describes two conditions either of which if satisfied will disqualify a person from claiming benefits under the Convention, unless the person qualifies for benefits under either paragraphs (3) or (4). Paragraph (2) contains a special rule aimed at companies that issue "alphabet" stock to third country residents in order to allow them to effectively claim benefits under the Convention. Although the structure of this Article differs from the limitation on benefits articles of other recent treaties (e.g., the Convention Between the Federal Republic of Germany and the United States of America) it achieves the same result.

Under paragraph (l), benefits will be denied to a resident of a Contracting State, such as a corporation, partnership or trust, if either

(i) 50 percent or more of the beneficial interests in the person (or, in the case of a corporation, 50 percent or more of the voting power or value or its shares) is owned, directly or indirectly, by individuals who are not residents of a Contracting State, and who are not citizens of a Contracting State who are subject to tax in that State on worldwide income, or

(ii) 50 percent or more of the person's gross income is used in substantial part, directly or indirectly, to meet liabilities in the form of deductible payments (including liabilities for interest or royalties) to persons who are residents of a state other than a Contracting State, and who are not citizens of a Contracting State who are subject to tax in that State on worldwide income.

The rationale for disqualifying a resident of a Contracting State in these two cases is that 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. Accordingly, 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. It also is necessary to require that the entity's deductible payments be made in substantial part to such treaty country residents or their equivalents.

Paragraph (2) address the potential for abuse when a company (or another company that controls that company) issues a class of shares that entitles its holders to a disproportionately high share of income derived in the other Contracting State, either from activities performed or assets located in that State. If 50 percent or more of the shares of this class is owned, directly or indirectly, by persons that would disqualify the corporation for benefits under subparagraph (a) of paragraph (1), then the Convention's benefits with respect income attributable to those assets or activities will be denied by paragraph (2). For example, a U.S. holding company could issue a class of shares (class B shares) entitling the class B shareholders to the dividends received from an Israeli subsidiary operating in Israel. If more than 50 percent of the vote and value of all of the U.S. company's shares is held by U.S. residents the holding company would not be denied benefits under paragraph (1). However, if a majority of the class B shares were held by third-country residents, paragraph (2) would deny the benefits of the Convention (reduced Israeli tax at source) with respect to the Israeli subsidiary's dividends. Were this not the rule and assuming there were a treaty in effect between the United States and the third country to reduce the U.S. dividend withholding tax, this structure would provide opportunities for third country residents to effectively claim the benefits of the Convention on dividends paid by the Israeli corporation.

Paragraph (3) identifies a number of classes of persons resident in one Contracting State that are entitled to treaty benefits from the other, either in full or with respect to particular items of income, notwithstanding paragraphs (1) and (2). First, under subparagraph (a), individuals who are residents of a Contracting State are, without qualification, entitled to benefits under the Convention. Second, subparagraph (b) provides that

> (i) a Contracting State or a political subdivision or local authority thereof,
>
> (ii) a corporation that is wholly owned by a Contracting. State or a political subdivision or local authority thereof, provided the corporation performs functions of a Governmental nature, and
>
> (iii) a body that is treated for tax purposes the same as a Contracting State or a political subdivision or local authority thereof and that performs functions of a Governmental nature,

are entitled to benefits under the Convention.

Subparagraph (c) of paragraph (3) provides a test for eligibility for benefits that looks not solely at objective characteristics of the person deriving the income, but at the nature of the activity carried on by that person and the connection between the income and that activity. Under subparagraph (c) a resident of a Contracting State deriving income from the other Contracting State is entitled to benefits if the recipient is engaged in an active trade or business in its State of residence, and the item of income in question is derived in connection with, or is incidental to, that trade or business. For this purpose an active trade or business does not include the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company. This relationship test is applied separately for each item of income, and it is intended that the provisions of this paragraph are self-executing. The tax

authorities say, of course, on review, determine that the taxpayer ham improperly interpreted the subparagraph and is not entitled to the benefits claimed.

The first six examples in the Memorandum of Understanding Regarding the Scope of the Limitations on Benefits Article in the Convention Between the Federal Republic of Germany and the United States of America illustrate the Situations intended to be covered by this provision. For example, income is considered "derived in connection with" an active trade or business when the income is a dividend paid to a United States manufacturing company by its sales subsidiary in Israel that is selling in Israel the output of the U.S. parent. Income would be considered "incidental to" an active trade or business if, for example, the income were dividends earned by an Israeli corporation from investing some of its working capital, temporarily, in U.S. preferred shares. Even if the Israeli company has no other activities in the United States, the dividends from those shares would be considered incidental to the active business of the company in Israel, and would be entitled to U.S. treaty benefits.

Under subparagraph (d) of paragraph (3), a corporation that 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 (5) of the Article to mean, in the United States, the NASDAQ System and any stock exchange that is registered as a national securities exchange with the Securities and Exchange Commission for purposes of the Securities Exchange Act of 1934. In Israel, the term means the Tel Aviv Stock Exchange, and any other Israeli stock exchange that say be approved by the Israeli Minister of Finance. The competent authorities may, by mutual agreement, recognize additional exchanges for purposes of subparagraph (d).

Subparagraph (e) of paragraph (3) provides that a not-for-profit organization that is a resident of a Contracting State is entitled to benefits from the other Contracting State if it satisfies two conditions:

> (i) it generally must be exempt from tax in its State of residence by virtue of its not-for-profit status; and
>
> (ii) 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.

The not-for-profit organizations dealt with in the subparagraph include pension funds, pension trusts, private foundations, trade unions, trade associations and similar organizations. Thus, an Israeli pension fund that provides pension benefits principally to Israeli residents would be entitled to benefits with respect to its U.S. source investment income.

Paragraph (4) 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 other provisions of the Article may, nevertheless, be granted benefits at the discretion of the competent authority of the Contracting State in which the income arises. The paragraph further provides that if a competent authority proposes to deny a request for benefits under this provision, either competent authority may request consultations with the other to discuss the issue.

The paragraph itself provides no guidance to competent authorities or taxpayers as to how the discretionary authority is to be exercised. It is understood, however, that in making determinations under paragraph (4), the competent authorities will take into account all relevant facts and circumstances. The factual criteria that 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. Paragraph 13 of the Exchange of Notes, for example, states the understanding that benefits would be likely to be granted by the competent authority in the case of a resident of a Contracting State that did not pass the base-erosion test of paragraph (1) of the Article because of large interest payments on a bona-fide loan from a financial institution resident in a third country. For this purpose a "bona-fide loan" would not include a conduit financing arrangement recharacterized under section 7701(1) of the Code or Rev. Rul. 87-89, 1987-2 C.B. 195.

For purposes of implementing paragraph (4), 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 under one of the other provisions of the Article. It also is 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.

Subparagraph (c) of paragraph (4) provides that the competent authorities are expected to consult with a view to developing agreed procedures for the application of Article 25, including, as provided in paragraph 14 of the Exchange of Notes, the development of a Memorandum of Understanding to provide guidance to both taxpayers and tax administrations. It is further expected that as, over time, the tax authorities of the Contracting States gain experience in administering the provisions of Article 25, further guidance will be developed and published.

ARTICLE XIII

Article XIII of the Protocol amends Article 26 (Relief from Double Taxation) of the Convention. Paragraph (1) of Article XIII replaces paragraph (2) of Article 26. Due to changes in law, paragraph (2) of the Convention dealing with payments made or received on a compulsory loan to Israel is no longer relevant. The new paragraph (2) provides special rules for the tax treatment in both Contracting States of certain types of income derived from U.S. sources by U.S. citizens who are resident in Israel. Since U.S. citizens are subject to United States tax at graduated rates on their worldwide income, the U.S. tax on the U.S. source income of a U.S. citizen resident in Israel will often exceed the U.S. tax allowable under the Convention on an item of U.S. source income derived by a resident of Israel who is not a U.S. citizen. Without this provision U.S. citizens resident in Israel would potentially be subject to double taxation with respect to this income.

Subparagraph (a) of paragraph (2) provides a special Israeli credit rule with respect to items of income that are either exempt from U.S. tax or subject to reduced rates of U.S. tax under the provisions of the Convention when received by Israeli residents who are not U.S. citizens. The Israeli foreign tax credit allowed by subparagraph (a) under these circumstances, to the extent consistent with Israeli law, need not exceed the U.S. tax that 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 (3) of Article E (General Rules of Taxation). Thus, if a U.S. citizen resident in Israel receives U.S. source dividends, the Israeli foreign tax credit would be limited to 25 percent of the dividend-- the U.S. tax that may be imposed under subparagraph (a) paragraph (2) of Article 12 (Dividends) -- even if the shareholder is subject to a U.S. rate of tax of 31 percent (or more) because of his U.S. citizenship.

Subparagraph (b) of paragraph (2) deals with the potential for double taxation that can arise as a result of the absence of a full Israeli foreign tax credit for the U.S. tax imposed on its citizens resident in Israel. The subparagraph provides that the United States will credit the Israeli income tax paid, after the Israeli credit provided for in subparagraph (a). It further provides that in allowing the credit, the United States will not reduce its tax below the amount that is allowed as a creditable tax in Israel under subparagraph (a) (i.e., the amount that the United States may impose on an Israeli resident under the convention). Since the income that is dealt with in this paragraph is U.S. source income, special rules are required to resource some of the income as Israeli source in order for the United States to be able to credit the Israeli tax. This resourcing rule is provided for in subparagraph (c), which deems the items of income referred to in subparagraph (a) of paragraph (2) to be from Israeli sources to the extent, but only to the extent, necessary to avoid double taxation under subparagraph (b). Thus, no excess credits can be generated in applying this rule that can be used against U.S. tax on any other item of income.

Paragraph 2 of Article XIII of the Protocol makes a clarifying amendment to the Israeli foreign tax credit rule in paragraph (3) of Article 26. As amended, the paragraph makes clear that the Israeli foreign tax credit is applied in a manner consistent with the provisions end limitations of Israeli law concerning the provision of a foreign tax credit, as the law is in force at the time the provision is being applied. However, the law as it is applied at any time must be consistent with the general provisions of the paragraph, i.e., it must continue to provide for a full foreign tax credit for U.S. income tax.

Paragraph 3 of Article XIII of the Protocol adds a new paragraph (4) to Article 26 of the Convention. Paragraph (4) specifies how the source rules in Article 4 (Source of Income) are to apply for purposes of computing the foreign tax credit under Article 26. It provides, first, that the source rule for the taxation of gain on tangible or intangible assets in paragraph (6) of Article 4 (Source of Income) applies for the purpose of computing the foreign tax credit under Article 26. It is intended that this rule apply notwithstanding the saving clause of paragraph (3) of Article 6. Thus, where subparagraph (a) of paragraph (1) of Article 15 (Capital Gains) gives one Contracting State the right to tax the gain of a resident of the other on the alienation of shares in a corporation of the first-mentioned State, the gain will be sourced, for credit purposes, in that first-mentioned State. Paragraph (4) provides further that the other source rules in Article 4 also will apply for foreign tax credit purposes, to the extent not prohibited by the domestic law of the

contracting State that is providing the credit. Thus, in computing the U.S. foreign tax credit section 904(g) of the Code, which provides for particular source rules for foreign tax credit purposes, will apply. Moreover, other source rules in Article 4 also would yield to conflicting source rules of domestic law without regard to their date of enactment.

Article XVII of the Protocol, providing the rules for entry into force and effective dates for the Second Protocol, contains a rule that refers to Article 26. Article XVII of the Protocol provides that when the Second Protocol (and, by inference, the convention as amended by the second Protocol) enters into force, the penultimate sentence of paragraph (1) of Article 26 is to be read as if that sentence had entered into force on May 30, 1980. This is intended to ensure that any U.S. statutory enactment of source rules for foreign tax credit purposes after May 30, 1980, that were intended by the congress to apply notwithstanding any pre-existing treaty rule to the contrary, would apply under this convention.

The rules of paragraph (4) of Article 26 and of the penultimate sentence of paragraph (1) of Article 26 generally have the same effect. However, it is not intended that the penultimate sentence of paragraph (1) of Article 26 in any way limit or otherwise affect the source rules as determined under paragraph (4) of Article 26.

Finally, paragraph 15 of the Exchange of Notes clarifies that the meaning of the terms "stock or intangible" in paragraph (4) has the meaning ascribed to it in section 865(h) of the Code when the taxpayer elects under that section.

ARTICLE XIV

Article XIV of the protocol amends Article 27 (Nondiscrimination) of the Convention. Paragraph (1) of Article XIV replaces paragraph (1) of Article 27 of the Convention with a new paragraph (1). The new paragraph conforms more closely to the corresponding paragraph in the 1981 U.S. Model. Paragraph 1, as amended, provides that a citizen of one Contracting State may not be subject to taxation or connected requirements in the other Contracting State that are different from, or more burdensome than, the taxes and connected requirements imposed upon a citizen of that other State in the same circumstances. A citizen of a Contracting State is afforded protection under this paragraph even if he is not a resident of either contracting State. The paragraph also provides that the United States need not apply the same taxing regime to an Israeli citizen who is not resident in the United States that it applies to a U.S. citizen who is not resident in the United States because theme persons are not in the same circumstances. A U.S. citizen who is not a resident of the United States is subject to United States tax on his worldwide income, unlike a citizen of Israel who is not U.S. resident. Thus, Article 27 would not entitle an Israeli citizen 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. A U.S. citizen who is resident in a third country, however, is entitled, under this paragraph, to the same treatment in Israel as an Israeli citizen who is in similar circumstances.

Paragraph 2 of Article XIV of the Protocol adds a new paragraph (4) to Article 27 (Nondiscrimination). Paragraph (4) specifies that no provision of the Article will prevent either

Contracting State from imposing the branch tax described in Article 14A (Branch Tax). Thus, even if the branch tax were judged to violate the provisions of the other paragraphs of the Article, neither contracting State would be constrained from imposing the tax.

During the course of the negotiation of the Second Protocol, understandings were reached regarding the application of Article 27 to two aspects of U.S. tax law. Section 1446 of the Code imposes on any partnership with income that is effectively connected with a U.S. trade or business the obligation to withhold tax on amounts allocable to a foreign partner. In the context of the convention, this obligation applies with respect to an Israeli 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 share of, a U.S. resident partner. 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 Israeli partnerships, since the law requires that partnerships of both States withhold tax in respect of the distributive shares of non-U.S. partners. In distinguishing between U.S. and Israeli partners, the requirement to withhold on the Israeli 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 over-withheld, the partner can, as in other cases of over-withholding, file for a refund. For the same reasons, it also is understood that these provisions in section 1446 do not violate paragraph (3) of the Article.

The 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, because the assets' built-in gain will be recognized when the parent sells or distributes the asset. This exception does not apply to distributions to parent corporations that 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 (3) 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 (3) 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 that would not be so subject -- not only foreign corporations, but also tax-exempt organizations.

ARTICLE XV

Article XV of the Protocol amends Article 29 (Exchange of Information) of the Convention, by replacing paragraph (1) of Article 29 with a new paragraph. As amended, paragraph (1) provides for the exchange of information between the competent authorities of the Contracting States. The information to be exchanged is that pertinent for carrying out the provisions of the Convention or the prevention of fraud or evasion in relation to U.S. or Israeli taxes that are covered by 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. The exchange must, however, be for the purpose of preventing fraud or evasion with respect to that tax.

Paragraph (1) also provides assurances that any information exchanged will be treated as secret. Information received may be disclosed only to persons or authorities concerned with the assessment (including judicial determination), collection, or administration of the taxes to which the Article relates. 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. Otherwise confidential information may be received by these bodies but only for their use in the performance of their role in overseeing the administration of U.S. tax laws.

ARTICLE XVI

Article XVI of the Protocol amends Article 31 (Entry Into Force) of the Convention, by replacing the rule in subparagraph (b) of Article 31 providing the effective date for taxes other than withholding taxes (which is provided for under subparagraph (a)). Subparagraph (b), as amended, provides alternative effective date rules, depending on the time of the year that the Convention enters into force, according to the provisions of the introductory language of Article 31. If the Convention enters into force prior to July 1 of any calendar year, the Convention will have effect, for taxes other than withholding taxes, for taxable years beginning on or after January 1 of the year in which the Convention enters into force. If, however, the Convention enters into force after June 30 of any calendar year, it will have effect, for taxes other than withholding taxes, for taxable years beginning on or after January 1 of the year following entry into force of the Convention.

ARTICLE XVII

Article XVII provides the rules for the entry into force of the second protocol. The Protocol is subject to ratification by both contracting States. It will enter into force 30 days after the exchange of instruments of ratification, and its provisions will take effect in accordance with the provisions of Article 31 (Entry Into Force) of the Convention.

A special rule in Article XVIII relating to the applicable source rules for U.S. foreign tax credit purposes is described in the explanation of Article 26 (Relief from Double Taxation).

EXCHANGE OF NOTES (PROTOCOL 2)

Two paragraphs in the Exchange of Notes were not described above in connection with Articles of the Protocol.

Paragraph 8 relates to Article 10 (Grants) of the Convention. It clarifies that the failure by Israel to include a grant in the basis of stock or assets for income tax purposes is understood not to mean that the grant is "taxed by Israel".

Paragraph 16 makes clear that a reference in the Convention to the currency of one of the Contracting States is to be understood to be a reference to the currency as it is named at the time the relevant rule of the Convention is being applied. Thus, the references in Articles 18 (public Entertainers) and 24 (Students and Trainees) to Israeli pounds, are understood today to be a reference to Israeli shekels.