New Italy-U.S. Income Tax Treaty

A New Income Tax Treaty Between Italy and the United States Has Been Ratified

SUMMARY

In March 2009, Italy ratified a new income tax treaty between Italy and the United States (the “Treaty”) and a related protocol (the “Protocol”), both of which will enter into force when instruments of ratification are exchanged. The Treaty and Protocol had been signed by Italy and the U.S. on August 25, 1999 and ratified by the U.S. Senate in November 1999, subject to certain limitations discussed further below.

The Treaty, as amended by the Protocol, makes a number of significant changes to the prior income tax treaty, as modified by its 1984 protocol (the “Prior Treaty”), including the following:

- **Dividends.**
  - Relaxes the threshold for qualifying for the 5% reduced withholding tax rate on intercorporate dividends;
  - Eliminates the 10% withholding tax rate on dividends paid to 10% corporate shareholders;
  - Exempts from source-state taxation dividends received by qualified governmental entities; and
  - Provides new rules governing the taxation of dividends paid by REITs and RICs.
- **Branch Profits Tax.** Allows a maximum 5% branch profits tax and a 10% branch-level tax on excess interest.
- **Interest.** Reduces the general withholding tax rate on interest from 15% to 10% and expands the categories of interest income exempt from source-state withholding tax.
- **Royalties.**
  - Reduces the general withholding tax rate on royalties from 10% to 8%;
• Exempts certain royalties from source-state taxation that had been subject to 5% taxation under the Prior Treaty; and

• Provides a reduced 5% withholding rate on royalties for the use of, or the right to use, computer software or industrial, commercial or scientific equipment.

• **Arbitration.** Provides for the use of binding arbitration (but only after procedures are finalized by way of exchange of diplomatic notes between Italy and the U.S.) if the competent authorities cannot come to mutual agreement and if consented to by each of the Italian and U.S. competent authorities and the concerned taxpayer(s).

• **Limitation on Benefits.** Significantly expands the Limitation on Benefits article so that it aligns more closely with recent treaties entered into by the U.S.

If instruments of ratification are exchanged prior to the end of April 2009, the Treaty and Protocol will generally take effect with respect to provisions relating to withholding taxes on June 1, 2009 and otherwise for taxable periods beginning on or after January 1, 2010. The Treaty provides a 12-month grace period, during which a taxpayer entitled to greater relief under the Prior Treaty may elect to apply the Prior Treaty but only in its entirety.

**DISCUSSION**

**Dividends and Branch Profits Tax**

**Dividends**

The threshold for qualifying for the 5% withholding tax rate on intercorporate dividends has been reduced so that beneficial owners qualify if they own 25% or more of the payer’s voting stock for at least 12 months before the dividend is declared. Under the Prior Treaty, this lowest rate was available only to shareholders owning more than 50% of the corporation’s voting shares for that period. Unlike the Prior Treaty, which provided a special 10% rate on intercorporate dividends for beneficial owners owning between 10% and 50% of the payer’s voting stock, the Treaty does not provide a special intercorporate dividends rate where share ownership is less than 25% of the corporation’s voting stock, and dividends paid to such owners will be subject to the 15% Treaty withholding tax rate (the same as under the Prior Treaty) that is generally applicable to portfolio dividends.

According to the Department of the Treasury Technical Explanation of the Treaty (the “Technical Explanation”), shares are considered voting stock for purposes of applying the 5% withholding rate if they provide the power to elect, appoint, or replace any person vested with the powers ordinarily exercised by the board of directors of a U.S. corporation. In addition, according to the Technical Explanation, a company holding shares through fiscally transparent entities (e.g., partnerships or disregarded entities) is treated as owning its proportionate interest in the shares held by such intermediate entities and thus may be entitled to the reduced Treaty rates on dividends paid on the underlying shares, though qualifying under this provision may require review of the intermediate agreements (e.g., the partnership agreement).
The Treaty adds a new exemption from source-state taxation for dividends paid to qualified governmental entities, so long as the qualified governmental entity holds, directly or indirectly, less than 25% of the payer’s voting stock.

A “qualified governmental entity” for this purpose is any of the following:

- any person or body of persons that constitutes a governing body of Italy or the U.S., or of a political or administrative subdivision or local authority of Italy or the U.S.;
- a person that is wholly owned, directly or indirectly, by Italy or the U.S., provided that
  - it is organized under the laws of Italy or the U.S., as the case may be,
  - its earnings are credited to its own account with no portion of its income inuring to the benefit of any private person, and
  - its assets vest in Italy or the U.S., as the case may be, or in a political or administrative subdivision or local authority thereof upon dissolution; or
- a pension trust or fund of a person described above that is constituted and operated exclusively to administer or provide pension benefits.

An entity, other than an entity described in the first bullet point above, does not qualify as a qualified governmental entity if it carries on commercial activities.

The Protocol clarifies that the term “qualified governmental entity” includes (but is not limited to) the following:

- in the case of the U.S.:
  - the Federal Reserve Banks;
  - the Export-Import Bank; and
  - the Overseas Private Investment Corporation;
- in the case of Italy:
  - La Banca d’Italia (the Central Bank);
  - L’Istituto per il Commercio con l’Estero (the Foreign Trade Institute); and
  - L’Istituto per l’Assicurazione del Credito all’Esportazione (the Official Insurance Institute for Export Credits);

and such financial institutions, the capital of which is wholly owned by Italy or the U.S. or any state or political or administrative subdivision or local authority as may be agreed by the competent authorities of both Italy and the U.S.

The Treaty provides that dividends from regulated investment companies (“RICs”) and real estate investment trusts (“REITs”) do not qualify for the 5% intercorporate dividends rate. RIC dividends are taxed at 15%, while REIT dividends qualify for the 15% rate only if
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- the beneficial owner is an individual owning no more than 10% of the REIT;
- the dividends are paid with respect to a publicly traded class of stock and the beneficial owner is a person owning no more than 5% of any class of the REIT’s stock; or
- the beneficial owner owns no more than 10% of the REIT and the REIT is diversified.\(^2\)

Otherwise, REIT dividends are taxed at the full 30% withholding rate under domestic U.S. tax law. The Technical Explanation explains that higher withholding rates are imposed on RIC and REIT shareholders to prevent potential abuse of RICs and REITs as conduits for reduced withholding. For example, if an Italian corporation wished to acquire a diversified portfolio of U.S. corporate shares, it could either own such shares directly or hold those shares through a RIC. Absent the higher withholding rates imposed on RIC shareholders under the Treaty, interposing a RIC would transform portfolio dividends, taxable at 15% under the Treaty, into direct investment dividends taxable at 5% under the intercorporate dividends provision of the Treaty. Thus, to provide equitable treatment for Italian corporations investing in the U.S., higher withholding rates are imposed on RIC and REIT shareholders.

**Branch Profits Tax**

The Treaty permits Italy and the U.S. to impose a branch profits tax on a corporation resident in the other state at a maximum rate of 5% to the extent of the corporation’s “dividend equivalent amount”. Generally, the dividend equivalent amount for any year approximates the dividend that a U.S. branch office would have paid during the year if the branch had been operated as a separate U.S. subsidiary company. According to the Technical Explanation, if Italy enacts a branch profits tax, the base of its tax would be limited to an analogous amount. The Prior Treaty did not permit a branch profits tax.

**Interest**

The Treaty reduces the general withholding tax rate on interest from 15% to 10%. It also expands the categories of interest income exempt from source-country taxation under the Treaty to include the following:

- Interest beneficially owned by a “qualified governmental entity”\(^3\) that owns, directly or indirectly, less than 25% of the capital of the payer;
- Interest paid with respect to debt guaranteed or insured by a qualified governmental entity of either Italy or the U.S. and beneficially owned by a resident of the other state;
- Interest paid or accrued with respect to a sale on credit of goods, merchandise, or services provided by one enterprise to another enterprise; or
- Interest paid or accrued in connection with the sale on credit of industrial, commercial or scientific equipment.

The Protocol provides that an excess inclusion of a residual interest in a REMIC, however, will be subject to the full 30% U.S. withholding tax.
The Treaty adds a provision permitting the U.S. to treat “excess interest” paid by the U.S. branch of an Italian resident as U.S. source income subject to 10% U.S. tax on a gross basis. Excess interest is defined for these purposes as the excess of

- interest allocable to the profits of the Italian resident that (i) are attributable to a permanent establishment of the Italian resident in the U.S. or (ii) are subject to U.S. taxation as income or gain from immovable (i.e., real) property located in the U.S. (generally interest that an Italian resident may deduct in computing its U.S. taxable income) over

- the interest actually paid by that permanent establishment or trade or business.

**Royalties**

The Treaty has substantially modified the treatment of royalties under the Prior Treaty. The Treaty:

- Exempts from source-state withholding tax royalties paid with respect to a copyright of literary, artistic or scientific work (excluding computer software, motion pictures, films, tapes or recording devices used for radio or television broadcasting), which were subject to 5% withholding under the Prior Treaty.

- Provides a reduced 5% withholding rate on the gross amount of royalties for the use of, or the right to use, computer software or industrial, commercial or scientific equipment.4

- Lowers the withholding rate on other royalty income from 10% to 8%.

**Pensions**

The Treaty clarifies that social security or other similar payments made by one state to a resident of the other state shall be taxable only in the state of residence. The Treaty also includes an anti-abuse rule providing that if a resident of one state becomes a resident of the other state, lump-sum payments or severance payments received after the change of residence but paid with respect to employment exercised in the original state of residence shall be taxable in the original state.

In addition, the Treaty provides that, with respect to an individual participating in a recognized pension plan in one state and performing dependent or independent personal services in the other state (for example, an Italian resident working in the U.S. who participates in a recognized Italian pension plan), pension plan contributions by such employee shall be deductible or excludible in computing his or her taxable income in that other state (in our example, contributions made to the Italian pension plan would be deductible for purposes of computing the Italian resident’s U.S. taxable income). The Treaty also provides that benefits accrued under the plan will not be treated as part of the employee’s taxable income and shall be deductible in computing the profits of his or her employer in that other state (again, for our example, the U.S.). The rules set out in this paragraph only apply if the employer or employee had made contributions to the plan (or a similar predecessor plan) before the employee arrived in the other state and the competent authority of such state has agreed that the pension plan generally corresponds to a pension plan recognized for tax purposes by that state. (With respect to the U.S., the Technical Explanation indicates that “it is understood” that IRAs, Roth IRAs, SEPs and 403(b) plans qualify for
these purposes, and with respect to Italy, the Protocol states that *fondi pensione* qualify.) The Treaty provides that the benefits granted under this rule shall not exceed the benefits that would be allowed by the other state to its residents for contributions to or benefits otherwise accrued under an analogous plan.

**Relief From Double Taxation – Foreign Tax Credits**

The Treaty clarifies which Italian taxes are treated as income taxes and therefore creditable for U.S. federal income tax purposes. The Treaty, consistent with the Prior Treaty and U.S. domestic tax law, allows a U.S. citizen or resident a foreign tax credit for Italian income taxes and also allows a U.S. company that receives dividends from an Italian company a deemed-paid tax credit for the Italian company’s Italian income taxes, but only if the U.S. company owns 10% or more of such Italian company’s voting stock. The credit is to be computed in accordance with and remain subject to U.S. domestic tax law.

The Treaty states that, for these purposes, the individual income tax (*l'imposta sul reddito delle persone fisiche*) and the corporation income tax (*l'imposta sul reddito delle persone giuridiche*) are income taxes available for credit against U.S. tax liabilities. In addition, the Treaty provides that the Italian regional tax on productive activity (*l'imposta regionale sulle attività produttive* or “IRAP”) is also treated as a creditable income tax, but limits the amount of IRAP that is creditable for U.S. tax purposes. The creditable amount is the product of the total amount of IRAP paid multiplied by a fraction, the numerator of which is the adjusted IRAP base as computed under Italian tax law minus labor and interest expense not otherwise allowed as a deduction for purposes of computing IRAP, and the denominator of which is the total IRAP base as determined under Italian tax law. According to the Technical Explanation, the amount of IRAP creditable for U.S. tax purposes is limited in this way in order to approximate the portion of IRAP tax that is imposed on a taxpayer’s business profits and that therefore represents a net income tax.

**Limitation on Benefits**

The Protocol includes a comprehensive Limitation on Benefits article that is significantly more restrictive than the one provided in the Prior Treaty. Under the Limitation on Benefits article, a resident of Italy or the U.S. is only eligible to claim Treaty benefits if it also satisfies one of the tests described below.

**Individuals & Qualified Governmental Entities**

Individual residents of Italy and the U.S. who beneficially own the income in question will be entitled to all Treaty benefits. (Individuals who receive income as a nominee on behalf of a third-country resident may be denied benefits under the Treaty.) Qualified governmental entities as described above will also be entitled to all benefits under the Treaty.

**Publicly-Traded Corporation Test**

A company resident in Italy or the U.S. will be entitled to all Treaty benefits if all the shares in the class or classes of shares that represent more than 50% of the company’s voting power and value are regularly
traded on a “recognized stock exchange” located in either Italy or the U.S. A “recognized stock exchange” for this purpose means NASDAQ and any stock exchange registered with the SEC as a national securities exchange for purposes of the Securities Exchange Act of 1934, and any stock exchange constituted and organized under Italian law. The Competent Authorities may agree in the future to include other stock exchanges in this category. The Technical Explanation clarifies that the term “regularly traded” for this purpose will be defined in accordance with the domestic tax laws of Italy or the U.S., as the case may be. According to the Technical Explanation, with respect to the United States and pursuant to existing U.S. tax law, a class of shares will generally be treated as “regularly traded” if

- trades in the class of shares are made in more than de minimis quantities on at least 60 days during the taxable year, and
- the aggregate number of shares in the class traded during the year is at least 10% of the average number of shares outstanding during the year.

**Subsidiary of a Publicly-Traded Corporation Test**

Under this test, a company will be entitled to all Treaty benefits if 50% or more of each class of its shares (not just the class or classes of shares accounting for more than 50% of the company’s vote and value) is directly or indirectly owned by five or fewer companies that qualify as a publicly-traded corporation under the test described above. While indirect ownership is permitted, any intermediate entities must qualify

- as a publicly-traded corporation,
- as a subsidiary of a publicly-traded corporation,
- as a tax-exempt organization or pension fund as defined for purposes of the Limitation on Benefits Article, or
- under the ownership / base erosion test described below.

**Tax-Exempt Organizations and Pension Funds**

A tax-exempt organization will qualify for all Treaty benefits if it qualifies as a resident under the Protocol—in other words, if the tax-exempt organization is a legal entity generally exempt from tax in Italy or the U.S. and established and maintained in Italy or the U.S., as the case may be, exclusively for a religious, charitable, educational, scientific, or other similar purpose.

A pension fund, meaning an otherwise tax-exempt entity that provides pension and other benefits to employees pursuant to a plan, will qualify for all Treaty benefits so long as more than half of its beneficiaries, members or participants are individual residents of either Italy or the U.S.

**Ownership / Base Erosion Test**

In order to qualify for all Treaty benefits under this test, a legal entity resident in Italy or the U.S. must satisfy each of the following two requirements:
Ownership Test. 50% or more of each class of beneficial interests in the entity (in the case of a corporation, 50% or more of each class of its shares) must be owned on at least half the days of the entity’s taxable year by persons who are themselves entitled to Treaty benefits either as individuals, qualified governmental entities, publicly-traded corporations or subsidiaries of publicly-traded corporations, tax-exempt organizations, or pension funds. The ownership may be indirect if each intermediate entity also qualifies for Treaty benefits as one of these types of entities.

Base Erosion Test. Less than 50% of the entity’s gross income for the taxable year must be paid or accrued, directly or indirectly, to non-residents of Italy or the U.S. (unless the payment is attributable to a permanent establishment of the non-resident located in either Italy or the U.S.), in the form of payments that are tax-deductible in the entity’s state of residence. Gross income, for purposes of establishing residence in the U.S., is defined by reference to U.S. federal income tax principles.

Active Trade or Business Test
A resident of Italy or the U.S. that is not generally entitled to all Treaty benefits under one of the tests described above will be entitled to receive Treaty benefits with respect to items of income that are connected to an active trade or business conducted in its state of residence if the following three requirements are satisfied:

- the resident is engaged in the active conduct of a trade or business in its state of residence;
- the income derived from the other state is derived in connection with, or incidental to, that trade or business; and
- the trade or business is substantial in relation to the activity in the other state that generated the item of income.

With respect to the first requirement of the three-part test, the Protocol provides that the business of making or managing investments will not be considered an active trade or business unless the activity is a banking, insurance or securities activity conducted by a bank, insurance company or registered securities dealer.

With respect to the second requirement of the three-part test, the Protocol indicates that income is derived in connection with a trade or business in the taxpayer’s state of residence if the income-producing activity in the other state is a line of business that “forms a part of” or is “complementary” to the trade or business conducted in the state of residence by the income recipient. According to the Technical Explanation, a business activity will generally be treated as “forming a part” of a business activity conducted in the other state if the two activities involve the design, manufacture or sale of the same products or type of products or the provision of similar services. The Technical Explanation also provides that, in order for activities to be “complementary” for this purpose, the relevant activities should be part of the same overall industry or be related such that the success or failure of one activity will tend to result in success or failure for the other. Further, the Protocol provides that a resident will be entitled to Treaty benefits with respect to income derived from the other state if the income is “incidental” to the trade or business conducted in the recipient’s state of residence. Income is treated as “incidental” for this purpose...
if the production of such income facilitates the conduct of the trade or business in the other state (e.g., according to the Technical Explanation, temporary investment of working capital derived from a trade or business will qualify as "incidental" income for this purpose).

With respect to the third requirement of the three-part test, the Protocol indicates that the determination of whether a trade or business is "substantial" will depend on "all the facts and circumstances", but also provides a safe harbor. Under this safe harbor, a trade or business will be deemed "substantial" if the average of the following three ratios exceeds 10% and each individual ratio exceeds 7.5%:⁵

- the value of the assets in the state of residence to the assets used in the other state;
- the gross income derived in the state of residence to the gross income derived in the other state; and
- the payroll expense in the state of residence to the payroll expense in the other state.

**Determination of the Competent Authority**

If a resident of Italy or the U.S. is not otherwise entitled to Treaty benefits, the competent authority of the state from which benefits are claimed may grant benefits to such a resident at its discretion.

**Mutual Agreement & Arbitration**

The Treaty, as modified by the Protocol and Memorandum of Understanding signed contemporaneously with the Treaty, sets forth a mutual agreement procedure to be used to resolve disputes under the Treaty. The Treaty includes a new voluntary arbitration process for disputes that are not otherwise resolved by the mutual agreement procedure, provided that arbitration is agreed to by the competent authorities and relevant taxpayer(s). This arbitration procedure, however, only becomes effective if Italy and the U.S. decide to implement it through a further exchange of diplomatic notes.

Like the Prior Treaty, the Treaty provides a mutual agreement procedure, under which a taxpayer may, irrespective of potential remedies under domestic law, present its case to the competent authority of its state of residence (or, in the case of a dispute relating to the non-discrimination provisions, to the competent authority of its state of nationality). The Treaty, unlike the Prior Treaty, provides that this case must be presented within three years from its first notification of the tax being disputed. According to the Technical Explanation, the term "first notification" should be interpreted in the way most favorable to the taxpayer so that the taxpayer is not time-barred from presenting the claim. In addition, like the Prior Treaty, the Treaty provides that, if the competent authority is unable to resolve the matter by itself, it will cooperate with the other competent authority to attempt to reach a satisfactory solution. Unlike the Prior Treaty, under the Treaty, if agreement is reached, the agreement is to be implemented notwithstanding the expiration of any relevant statutes of limitations under the domestic law of the contracting states.

Under the proposed arbitration procedures, if the competent authorities cannot reach an agreement and both competent authorities and the relevant taxpayer(s) agree, the case may be submitted for arbitration,
provided that the taxpayer(s) agrees in writing to be bound by the decision of the arbitration board. This arbitration provision, however, will not go into effect upon the Treaty entering into force. The Protocol, instead, provides that the competent authorities should consult within three years after the Treaty’s entry into force to determine whether or not to implement the arbitration provisions through the exchange of diplomatic notes. The Memorandum of Understanding sets forth certain procedures for the arbitration process should the countries decide to implement the arbitration provisions.

If the existing arbitration provisions set forth in the Memorandum of Understanding, as drafted, are implemented, the following procedures will apply:

- If the competent authorities fail to reach an agreement within two years of the date on which the case was submitted to one of them, they may voluntarily submit to arbitration.
- Then, the competent authorities shall establish an arbitration board consisting of at least three members. Each competent authority shall appoint the same number of members, and these members shall agree on the appointment of the other member(s). The other members shall be from either Italy or the U.S. or from another OECD member country. Either the competent authorities or the arbitration board may agree on the applicable rules of procedure. Taxpayers and/or their representatives will be allowed to present their views to the arbitration board.
- The decision of the arbitration board will be binding on both states and the taxpayer(s) with respect to that case. The decision of the arbitration board will not be treated as having precedential effect, but decisions will generally be taken into account in subsequent competent authority cases involving the same taxpayer, the same issues and substantially similar facts, and may be taken into account in other cases where appropriate.

The Treaty provides that the competent authorities may consult to facilitate the elimination of double taxation with respect to specific cases not provided for under the Treaty and to resolve any confusion or difficulties with respect to the interpretation or application of the Treaty. In particular, according to the Technical Explanation, competent authorities may address cases that are within the spirit of the Treaty but not specifically covered—for example, a case of double taxation arising from a transfer pricing adjustment between two permanent establishments of a third-country resident.

In addition, the Technical Explanation states that the competent authorities may apply the mutual agreement procedures of the Treaty to transactions arising in taxable years of the Prior Treaty, notwithstanding that the Treaty was not yet in effect at the time of those transactions.

Other Changes

- **Expansion of Rules Determining Residence.**

  - **Individuals.** The Protocol provides that a U.S. citizen or green-card holder is a U.S. resident for Treaty purposes only if he or she has a substantial presence, permanent home or habitual abode in the United States. Therefore, a U.S. citizen residing overseas may not be entitled to Treaty benefits as a U.S. resident.

  - **Fiscally Transparent Entities.** The Treaty and Protocol provide that income derived by a fiscally transparent entity (e.g., a partnership, estate or trust) is treated as derived by a...
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resident of the country only to the extent that the income is taxable in that country as the income of a resident.

- **Permanent Establishments No Longer in Existence.** The Treaty, consistent with U.S. tax law principles, allows certain types of income or gain (including business profits, dividends, capital gain, interest income and royalty income) attributable to a permanent establishment to be taxed by the state where the permanent establishment was located even if payment or accrual of the relevant income or gain is deferred until after the permanent establishment has ceased to exist.

- **Independent Personal Services.** The Treaty eliminates source-state taxation of income derived from the performance of independent personal services unless such income is attributable to a fixed base in that state; the Prior Treaty allowed for source-state taxation of such income, whether or not attributable to a fixed base, if the individual was present in the state for more than 183 days of the taxable year.

- **Transportation Income.** The Treaty and Protocol in general retain the reciprocal exemption under the Prior Treaty for international transportation income derived from the operation of ships or aircraft. The Protocol adds, however, a new provision that if any state or locality in the U.S. imposes tax on profits of Italian enterprises from the operation in international traffic of ships or aircraft, Italy may impose IRAP on such profits of a U.S. enterprise.

- **Main Purpose Test.** The Treaty and Protocol set forth anti-abuse provisions that eliminate Treaty benefits under the provisions relating to dividends, interest, royalties and “other income” if the main purpose or one of the main purposes of any concerned person was to take advantage of the Treaty by means of certain transactions or structures. The Protocol authorizes the use of mutual assistance provisions under the Treaty in order to develop agreement on the application of these anti-abuse rules. Congress’s Joint Committee on Taxation Explanation of the Treaty and Protocol expressed concern that these anti-abuse provisions were too vague and potentially over-reaching and inconsistent with other recent U.S. income tax treaties, and the U.S. Senate deleted these provisions from the Treaty and Protocol in its ratification process. By way of an exchange of diplomatic notes in 2006 and 2007, the Italian Minister of Foreign Affairs formally consented to the U.S. Senate’s deletion of these provisions.

### Effective Date

If instruments of ratification are exchanged prior to the end of April 2009, the Treaty and Protocol will generally take effect with respect to provisions relating to withholding taxes on June 1, 2009 and otherwise for taxable periods beginning on or after January 1, 2010. The Treaty provides a 12-month grace period, during which a taxpayer entitled to greater relief under the Prior Treaty may elect to apply the Prior Treaty but only in its entirety.

* * *
ENDNOTES

1 Convention between the Government of the United States of America and the Government of the Italian Republic for the Avoidance of Double Taxation with respect to Taxes on Income and the Prevention of Fraud or Fiscal Evasion.

2 The Technical Explanation clarifies that a REIT will be considered to be “diversified” for this purpose if the value of no single interest in the REIT’s real property exceeds 10% of the REIT’s total interests in real property. For this purpose, foreclosure property and mortgages will not be treated as interests in real property unless, in the case of a mortgage, it has substantial equity components. A look-through rule applies to partnership interests held by a REIT so that a REIT will be treated as owning directly the interests in real property held by the partnership.

3 A “qualified governmental entity” for this purpose has the same meaning as discussed above in the “Dividends” section.

4 The Technical Explanation states that consideration received for the use, or the right to use, computer software can be treated either as royalties or as business profits, depending on the facts and circumstances of the transaction giving rise to the payment. The decisive factor would generally be the nature of the rights transferred. For example, as discussed by the negotiators of the Treaty, a retail sale of “shrink wrap” software generally would not be treated as giving rise to royalty income, notwithstanding its characterization as a license under copyright law, but would instead give rise to business profits.

5 If any individual ratio does not exceed 7.5%, then the average for the three preceding taxable years may be used instead for that particular ratio.
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