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TREASURY DEPARTMENT TECHNICAL EXPLANATION OF THE
CONVENTION AND PROTOCOL BETWEEN THE
GOVERNMENT OF THE UNITED STATES OF AMERICA AND THE GOVERNMENT OF
THE REPUBLIC OF KAZAKHSTAN
FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE
PREVENTION OF FISCAL EVASION WITH RESPECT TO
TAXES ON INCOME AND CAPITAL SIGNED AT ALMATY ON
OCTOBER 24, 1993

INTRODUCTION

This is a technical explanation of the Convention and Protocol between the United States and the Republic of Kazakhstan signed on October 24, 1993 ("the Convention"). The Convention replaces the Convention Between the United States of America and the Union of Soviet Socialist Republics for the Avoidance of Double Taxation of Income, the Prevention of Fiscal Evasion with Respect to Taxes on Income, and the Elimination of Obstacles to International Trade and Investment, signed on June 20, 1973 ("the 1973 Convention"), as it applied to the United States and Kazakhstan.

The Convention is based on the Model Double Taxation Convention on Income and Capital, published by the OECD in 1977 and periodically updated and amended since that time ("the OECD Model"), the 1973 Convention, and other more recent U.S. income tax conventions. The U.S. Treasury Department has withdrawn its draft Model Income Tax Convention, published on June 16, 1981, and is currently developing a new model. The Convention reflects certain principles of the withdrawn U.S. Model that were relevant at the time the Convention was negotiated.

The Technical Explanation is an official guide to the Convention. It reflects the policies behind particular Convention provisions, as well as understandings reached with respect to the application and interpretation of the Convention.

The explanations of each article include explanations of any Protocol provision relating to that article. The explanations also take into account the mutual interpretations of certain provisions of the Convention reflected in the Memorandum of

Understanding, which was attached to a note dated August 15, 1994 from Mr. William Courtney, United States Ambassador to Kazakhstan, to Mr. Yerkishbay Derbisov, Minister of Finance, Republic of Kazakhstan, and which was referred to in the reply note from Mr. Yerkishbay to Mr Courtney dated September 13, 1994.

Article 1. GENERAL SCOPE

Paragraph 1 provides that the Convention applies to residents of the United States or Kazakhstan and, in some cases, may also apply to residents of third states. Article 4 defines a resident of the United States or Kazakhstan for the purposes of the Convention. Examples of cases where the Convention may affect residents of third states include the articles on non-discrimination (Article 24) and the exchange of information (Article 26).

Subparagraph 2 a) provides that the Convention may not increase the tax burden of residents of either Contracting State compared to what it would be under the State's respective domestic law provisions. Under subparagraph 2 b), the Convention also may not restrict a tax benefit conferred by any other agreement between the Contracting States.

Under this paragraph, a right to tax given by the Convention cannot be exercised unless domestic law also provides for such a tax. This does not mean, however, that a taxpayer may pick and choose among Internal Revenue Code ("Code") and Convention provisions in an inconsistent manner in order to minimize tax. For example, assume a resident of Kazakhstan has three separate businesses in the United States. One is a profitable permanent establishment and the other two are trades or businesses that would earn income taxable in the United States under the Code but do not meet the permanent establishment threshold tests of the Convention. Of the other two trades or businesses, one is profitable, and the other incurs a loss. Under the Convention the income of the permanent establishment is taxable, but the profit or loss of the other two businesses is ignored. Under the Code, all three businesses would be taxable. The loss in the one would be offset against the profits of the other two ventures. The taxpayer may not invoke the Convention to exclude the profits of the profitable trade or business and invoke the Code to claim the loss of the loss trade or business against the profit of the permanent establishment. (See Rev. Rul. 84-17, 1984-1 C.B. 10.) If the taxpayer invokes the Code for the taxation of all three ventures, he would not be precluded from invoking the Convention with respect, for example, to any dividend income he may receive from the United States that is not effectively connected with any of his business activities in the United States.

Paragraph 3 of Article 1 contains the traditional "saving" clause, which provides that each country may tax its own residents, citizens, and former citizens, in accordance with its domestic law, without regard to the Convention. Thus, the United States may tax its citizens, wherever resident, notwithstanding any provision of the Convention (unless the provision is specifically excepted from the saving clause). The United States also may tax its residents, notwithstanding any provision of the

Convention (except a provision specifically excepted from the saving clause). A person's "residence," for the purpose of the saving clause, is determined under Article 4 (Residence). Thus, the tie-breaker rules of paragraph 2 of Article 4 will determine the residence, including for saving clause purposes, of an individual (not a U.S. citizen) who is a resident of the United States under the Code, e.g., a "green card" holder, and also a resident of Kazakhstan under Kazakh law. If the individual is determined to be a resident of Kazakhstan under these tie-breaker rules, he or she will be entitled to U.S. benefits under the Convention.

Paragraph 3 also permits the taxation of certain former citizens. In the case of the United States, citizens whose loss of citizenship had as one of its principal purposes the avoidance of U.S. tax may be taxed in accordance with section 877 of the Code. There is not a comparable provision in Kazakh law dealing with former citizens. (Kazakhstan taxes on the basis of residence and also taxes non-residents who are employed overseas with the Kazakh government.)

As a consequence of the saving clause, each article of the Convention should be read as not providing benefits with respect to the U.S. taxation of U.S. citizens (wherever resident) or U.S. residents (as defined in Article 4) or with respect to Kazakhstan's taxation of Kazakh citizens or residents. However, paragraph 4 provides certain exceptions to the saving clause. Under subparagraph a), for example, U.S. residents and citizens are entitled to certain U.S. benefits provided under the Convention. Those benefits are: the correlative adjustments authorized by paragraph 2 of Article 7, the exemption of social security payments and other public pensions paid by Kazakhstan under paragraph 1 b) of Article 18, the exemption of child support paid by residents of Kazakhstan as provided in paragraph 5 of Article 18, the guarantee of a foreign tax credit provided in Article 23, the non-discrimination protection of Article 24, and the competent authority procedures of Article 25. Kazakh residents are entitled to the benefits provided by Kazakhstan under the same articles (and Kazakh citizens or former citizens would be entitled to the same benefits, if relevant).

Under subparagraph b) certain additional benefits are available to U.S. residents who are neither U.S. citizens nor "green card" holders; these are the benefits extended to employees of the Kazakh Government under Article 17, to visiting students, trainees and researchers under Article 19, and to members of diplomatic and consular missions under Article 27. This paragraph also applies reciprocally.

Article 2. TAXES COVERED.

This Article identifies the U.S. and Kazakh taxes to which the Convention applies.

In the case of the United States, the Convention applies to the Federal income taxes imposed by the Internal Revenue Code, but not including the accumulated earnings tax or personal holding company tax (which are considered penalty taxes) or social security taxes. In the case of Kazakhstan, the Convention applies to the taxes on profits and income provided by the laws "On Taxation of Enterprises, Associations and Organizations" and "On the Income Tax on Citizens of the Kazakh SSR, Foreign Citizens and Stateless Persons." The non-discrimination provisions of Article 24 apply to all taxes imposed at all levels of government. This is the only article that applies to state and local taxes. The exchange of information provisions of Article 26 apply to all national level taxes (including estate and gift and excise taxes), to the extent that the information exchanged is relevant to enforcement of the Convention or of any covered tax as long as such tax is applied in a manner that is not inconsistent with the Convention.

Under paragraph 2, the Convention will apply to any taxes that are substantially similar to those enumerated in paragraph 1 and that are imposed in addition to, or in place of, the existing taxes after October 24, 1993 (the date of signature of the Convention). In recognition of the fact that the Kazakh tax system is evolving, the paragraph adds that a tax imposed by one State subsequent to the signing of the Convention that is substantially similar to an existing tax of the other State covered by paragraph 1 will also be covered. For the same reason, paragraph 3 also includes in the Convention's coverage any national level tax on capital subsequently imposed by either Contracting State.

On April 24, 1995, Kazakhstan enacted a new tax law by presidential decree.¹ As part of the implementation of the new law, the presidential decree orders that all existing laws be repealed or revised as necessary to bring them into conformity with the new law. The new law is generally consistent with U.S. and OECD tax policies. Its application to U.S. residents who qualify for treaty benefits will be limited by the terms of the Convention.

Paragraph 2 also provides that the U.S. and Kazakh competent authorities will notify each other of significant changes in their taxation laws that are relevant to the operation of the

¹ The Decree of the President of the Republic of Kazakhstan, Having the Force of a Law, "On Taxes and Other Obligatory Payments to the Budget" (Almaty, April 24, 1995).

Convention and of official published materials that concern the application of the Convention.

Article 3. GENERAL DEFINITIONS

Paragraph 1 defines a number of basic terms used in the Convention. Certain others are defined in other articles of the Convention. For example, the term "resident of a Contracting State" is defined in Article 4 (Residence). The term "permanent establishment" is defined in Article 5 (Permanent Establishment). The terms "dividends," "interest," and "royalties" are defined in Articles 10, 11 and 12, respectively, which deal with the taxation of those classes of income.

The term "Contracting State" means the United States or the Republic of Kazakhstan, depending on the context in which the term is used.

The terms "United States" and "Kazakhstan" are defined in subparagraphs b) and c), respectively. The term "United States" is defined to mean the United States of America. The term does not include Puerto Rico, the Virgin Islands, Guam or any other U.S. possession or territory. When used geographically, the "United States" includes the territorial sea, the continental shelf and the economic zone of the United States, provided that any taxation therein is in accordance with international law and U.S. tax law. Currently, U.S. tax law applies on the continental shelf only with respect to the exploration for and exploitation of mineral resources (Code section 638). The term "Kazakhstan" means the Republic of Kazakhstan and, when used geographically, includes the territorial sea, the continental shelf, and the economic zone, provided that any taxation therein is in accordance with international law and Kazakh tax law.

Subparagraph d) defines the term "person" to include an individual, an estate, a trust, a partnership, a company and any other body of persons. Any such person may be a "resident" of a Contracting State for purposes of Article 4 and thus entitled to the benefits of the Convention.

The term "company" is defined in subparagraph e) as any entity treated as a body corporate for tax purposes. The Kazakh entities described in the second sentence of subparagraph e) are treated as companies, provided their profits are taxed at the entity level in Kazakhstan. In Kazakhstan, all legal entities (including a joint stock company, a limited liability company, and a joint venture), except simple partnerships and consortiums, are subject to tax on profits at the entity level. In the United States, the rules of Reg. § 301.7701-2 generally will be applied to determine whether an entity is taxed as a body corporate.

The Convention is drafted to refer to "residents" rather than "enterprises." The Kazakh delegation observed that existing models do not provide an adequate definition of an "enterprise of a Contracting State." Thus, it was decided to use instead the term "resident," for example, in Article 5 (Permanent Establishment) and Article 6 (Business Profits), obviating the need to define "enterprise."

Subparagraph f) defines the term "international traffic." The term means any transport by a ship or aircraft except when such transport is solely between places within the other (i.e., non-resident) State. (The operative provisions of Article 8 (Shipping and Air Transport) provide for exclusive residence State taxation of income from international shipping and air transport and are drafted such that, when the term "international traffic" is used, the "other" State always means the non-resident, source State.) The provisions of Article 8, together with the definition of "international traffic" in this Article, result in source-State exemption of income from shipping or air transport unless the transport is solely between points within the non-resident State. Thus, for example, the transport of goods or passengers by a Kazakh carrier solely between New York and Chicago (if that were permitted) would not be treated as transport in international traffic, and the resulting income would not be exempt from U.S. tax under Article 8. It would, however, be treated as business profits under Article 6 and would, therefore, be taxable in the United States only if attributable to a U.S. permanent establishment, and then only on a net basis. If, however, goods or passengers are carried by a Kazakh plane from Almaty to New York and then to Chicago, the trip would be in international traffic with respect to the carriage for those who continued to Chicago as well as for those who disembarked in New York.

Subparagraph g) defines the term "capital." The definition is relevant for purposes of Article 22 (Capital), which limits either Contracting State's ability to impose any capital taxes, including any capital taxes that may be enacted in the future.

The "competent authority" is the Government official charged with administering the provisions of the Convention and with attempting to resolve any doubts or difficulties which may arise in interpreting its provisions. The U.S. competent authority is the Secretary of the Treasury or his authorized representative. The Secretary of the Treasury has delegated the competent authority function to the Commissioner of Internal Revenue, who has, in turn, delegated the authority to the Assistant Commissioner (International). With respect to interpretive issues, the Assistant Commissioner acts with the concurrence of the Associate Chief Counsel (International) of the Internal Revenue Service. In Kazakhstan, the competent authority is the Minister of Finance or his authorized representative. In general

that function is assigned to the Deputy Minister of Finance or the Chief of the Department of Tax Reform.

Paragraph 2 provides that, in the application of the Convention, any term used but not defined in the Convention will have the meaning which it has under the law of the Contracting State whose tax is being applied, unless the context requires a different interpretation or the competent authorities agree to a common meaning.

Article 4. RESIDENCE

This Article sets forth rules for determining whether a person is a resident of a Contracting State for purposes of the Convention. Determination of residence is important because, as noted in the explanation to Article 1 (General Scope), as a general matter only residents of the Contracting States may, subject to Article 21 (Limitation on Benefits), claim the benefits of the Convention. The treaty definition of residence is used for all purposes of the Convention, including the saving clause of paragraph 3 of Article 1 (General Scope), but it is to be used only for purposes of the Convention.

The determination of residence for purposes of the Convention looks first to a person's liability to tax as a resident under the respective taxation laws of the Contracting States. For this purpose, "liability to tax" is interpreted as "subject to the taxation laws;" thus, a non-profit, tax-exempt entity may be a resident of a Contracting State. A person who, under those laws, is a resident of one Contracting State and not of the other need look no further. For purposes of the Convention, that person is a resident of the State in which he is resident under internal law.

In accordance with U.S. treaty and domestic tax policy, this Convention includes citizenship as one of the criteria of residence. Thus, a U.S. citizen resident in a third country is entitled to the benefits of this Convention on the same basis as an individual residing in the United States. If, however, a U.S. citizen or resident (e.g. a "green card" holder) is also a resident of Kazakhstan under its taxation law, the individual must look to the tie-breaker rules of paragraph 2, which assign one State of residence to such a person for purposes of the Convention. The U.S. citizen who is determined to be a resident of Kazakhstan under this paragraph would continue to be subject to U.S. taxation under the saving clause of paragraph 3 of Article 1 (General Scope), but a green card holder determined under paragraph 2 to be a resident of Kazakhstan would not be subject to the saving clause.

It is understood that the two Contracting States and their political subdivisions are to be treated as residents of those States for purposes of Convention benefits.

A person that is liable to tax in a Contracting State only in respect of income from sources within that State will not be treated as a resident of that Contracting State for purposes of the Convention. Thus, for example, a Kazakh consular official in the United States who is subject to U.S. tax on U.S. source investment income, but not on non-U.S. income, would not be considered a resident of the United States for purposes of the Convention. (In most cases such an individual also would not be a U.S. resident under the Code.)

A partnership, estate or trust will be treated as a resident of a Contracting State in accordance with the residence of the person liable to tax with respect to the income derived by the partnership, estate, or trust, i.e. to the extent that the income is taxed as the income of a resident, whether in the hands of the person deriving the income or in the hands of its partners or beneficiaries. This rule is applied to determine the extent to which the partnership, estate or trust is entitled to benefits with respect to income derived from the other Contracting State. Under Kazakh law, a "simple" partnership or a "consortium" is taxed on a flow-through basis, and trusts and estates generally are not used. Similarly, under U.S. law, an entity organized under a state law general or limited partnership statute generally is not, and an estate or trust often is not, a taxable entity. (Certain publicly traded partnerships and partnerships that are reclassified as associations under Reg. § 301.7701-2 will be taxable as corporations.) In addition, certain other forms of organization, such as limited liability companies, may be classified as partnerships for U.S. tax purposes. Thus, for purposes of the Convention, income received by an entity classified as a partnership for U.S. tax purposes will generally be treated as received by a U.S. resident to the extent included in the distributive share of partners or members who are themselves U.S. residents (looking through any partnerships which are themselves partners or members). Similarly, the treatment under the Convention of income received by a U.S. trust or estate will be determined by the residence for taxation purposes of the person subject to tax on such income, which may be the grantor, the beneficiaries, or the estate or trust itself, depending on the particular circumstances.

If, under the laws of the two Contracting States, and, thus, under paragraph 1, an individual is deemed to be a resident of both Contracting States, a series of tie-breaker rules is provided in paragraph 2 to determine a single State of residence for that individual. These rules come from the OECD Model. The first test is where the individual has a permanent home. If that test is inconclusive because the individual has a permanent home

available to him in both States, he will be considered to be a resident of the Contracting State where his personal and economic relations are closest, i.e., the location of his "center of vital interests." If that test is also inconclusive, or if he does not have a permanent home available to him in either State, he will be treated as a resident of the Contracting State where he maintains an habitual abode. If he has an habitual abode in both States or in neither of them, he will be treated as a resident of his Contracting State of citizenship. If he is a citizen of both States or of neither, the competent authorities are instructed to resolve his residence by mutual agreement. This could be the case, for example, where the individual is not a citizen of either Contracting State.

The tie-breaker rules of paragraph 2 apply only to individuals. Paragraph 3 seeks to settle dual residence issues for companies (defined in Article 3 as entities treated as a body corporate for tax purposes). Under U.S. law, a corporation that is created or organized under the laws of the United States or a state or the District of Columbia is liable to U.S. tax by reason of that incorporation and therefore is a resident of the United States under paragraph 1. A company that has its place of registration in Kazakhstan is liable to Kazakh tax by reason of that registration and therefore is a resident of Kazakhstan under paragraph 1. In most cases it is expected that the place of incorporation and registration will be the same. However, in the event that a company is incorporated in the United States but registered in Kazakhstan, it would be a resident of both countries under their respective domestic laws. Paragraph 3 provides that, in that event, the competent authorities will endeavor to establish a single country of residence. If they are unable to do so, the company will not be entitled to claim the benefits of the Convention as a resident of either Contracting State. It will continue to be considered a resident of both States for purposes of providing benefits to other persons who are entitled to Convention benefits (i.e., those who receive dividends, interest or royalties from the dual resident and who are entitled to the treaty's reduced rates of source country tax on those items of income) and for purposes of the domestic taxation laws of the two States.

Paragraph 4 provides that where a person, other than an individual or a company, is a resident of both Contracting States under their respective laws, the competent authorities will establish a single country of residence and agree on how the Convention is to apply to such a person.

Article 5. PERMANENT ESTABLISHMENT

This Article defines the term "permanent establishment," which is relevant to several articles of the Convention. The current or former existence of a permanent establishment in a

Contracting State is necessary under Article 6 (Business Profits) for that State to tax the business profits of a resident of the other Contracting State. Articles 10, 11 and 12 (dealing with dividends, interest, and royalties, respectively) provide for reduced rates of tax at source on payments of these items of income to a resident of the other State only when the income is not attributable to a permanent establishment or fixed base which the recipient has or had in the source State; if the income is attributable to a permanent establishment, Article 6 (Business Profits) applies (and if the income is attributable to a fixed base, Article 14 (Independent Personal Services) applies).

This Article is similar in most respects to the corresponding articles of the OECD Model and conforms with U.S. treaty policy. It does, however, depart from that Model and those policies in certain respects.

Paragraph 1 provides the basic definition of the term "permanent establishment." As used in the Convention, the term means a fixed place of business through which a resident of one Contracting State carries on business activities in the other Contracting State. It is not necessary that the resident be a legal entity. Point 1 of the Protocol makes clear that it is also unnecessary that the fixed place of business be owned by the resident. In the case of an individual, Article 14 (Independent Personal Services) uses the concept of a "fixed base" rather than a "permanent establishment," but the two concepts are considered to be parallel.

Paragraph 2 contains a list of examples of fixed places of business that constitute permanent establishments: a place of management, a branch, an office, a factory, a workshop, and a mine, well, quarry or other place of extraction of natural resources. The use of singular nouns in this illustrative list is not meant to imply that each such place necessarily represents a separate permanent establishment. In the case of mines or wells, for example, several such places of business could constitute a single permanent establishment if the project is a whole commercially and geographically (see the following discussion under construction sites and drilling operations). Mines, wells, or quarries are examples of fixed places that may not be owned by the resident of the other State but that can nonetheless form a permanent establishment of that resident.

Paragraph 3 adds that a construction site, installation or assembly project, or an installation or drilling rig (onshore or offshore) or ship used to explore for or exploit natural resources also constitutes a permanent establishment, but only if it lasts more than 12 months. This is the period provided for in the OECD Model, and it is consistent with U.S. treaty policy. The 12-month test applies separately to each individual site or project. A series of contracts or projects that are

interdependent both commercially and geographically is to be treated as a single project. For example, the construction of a housing development would be considered a single project even if each house were constructed for a different purchaser. Similarly, the drilling of several wells within the same geographic area and as part of the same commercial operation will be considered a single permanent establishment.

The 12-month period begins when work (including preparatory work carried on by the resident) physically begins in a Contracting State. A site should not be regarded as ceasing to exist when work is temporarily discontinued. If the 12-month threshold is exceeded, the site or project constitutes a permanent establishment from the first day.

The foregoing interpretation of paragraph 3 is based on the Commentaries to paragraph 3 of Article 5 of the OECD Model, which constitutes the generally accepted international interpretation of the language in paragraph 3 of Article 5 of the Convention.

The furnishing of supervisory services may give rise to a permanent establishment under paragraph 3. Supervisory services that do not themselves last for more than 12 months may nonetheless be an interrelated part of a construction project; in that case, the period of time during which supervisory services were carried on will be added to the time during which the construction is carried on for purposes of determining whether the building contractor meets the 12-month test. Supervisory services may be performed by the building contractor or by another enterprise (e.g., a subcontractor). If the services are performed by another enterprise, then such services may also constitute an independent permanent establishment of that other enterprise if they continue for more than 12 months. The addition of the reference to supervisory services generally is consistent with the OECD Model. The commentary to paragraph 3 of Article 5 of the OECD Model points out that activities of planning and supervision, as well as activities of subcontractors, are taken into account in determining whether the general contractor has a permanent establishment.

The furnishing of services, including consultancy services, by a resident of one Contracting State through employees or other personnel in the other State will give rise to a permanent establishment if such services last for more than 12 months. As is true with respect to the type of permanent establishment created through a construction project, time spent performing services with respect to the same or related service projects will be aggregated for purposes of applying this 12-month threshold. Although the preferred U.S. treaty policy is that services do not give rise to a permanent establishment unless performed through a fixed place of business or by a dependent agent, the United States has agreed to similar provisions in

other treaties with developing countries (for example, India and Indonesia and, more recently, the Czech Republic and the Slovak Republic). Moreover, the 12-month threshold agreed to in this Convention is much longer than the 183 days that the United States has accepted in these other treaties. The U.N. Model also contains a shorter period of an aggregate of 6 months in a 12 month period.

Paragraph 4 contains exceptions to the general rule of paragraph 1 that a fixed place of business through which a business is carried on constitutes a permanent establishment. The paragraph lists a number of activities that may be carried on through a fixed place of business but that, nevertheless, will not give rise to a permanent establishment. The use of facilities solely to store, display or deliver merchandise belonging to a resident will not constitute a permanent establishment of that resident. The maintenance of a stock of goods belonging to a resident solely for the purpose of storage, display or delivery, or solely for the purpose of processing by another resident will not give rise to a permanent establishment of the resident. The maintenance of a fixed place of business solely for purchasing goods or collecting information for the resident, or for carrying out any other activity of a preparatory or auxiliary character for the resident, such as advertising, the supplying of information, or the conduct of certain research activities, will not constitute a permanent establishment of the resident.

A combination of the activities described in paragraph 4 will not give rise to a permanent establishment.

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

Under paragraph 6, a resident of one State will not be deemed to have a permanent establishment in the other State merely because it carries on business in the other State through an independent agent, including a broker or general commission agent, as long as the agent is acting in the ordinary course of his business.

Paragraph 7 clarifies that a company that is a resident of a Contracting State will not be deemed to have a permanent establishment in the other Contracting State merely because it

controls, or is controlled by, a company that is a resident of that other Contracting State or that carries on business in that other Contracting State. The determination whether a permanent establishment exists will be made solely on the basis of the factors described in paragraphs 1 through 6 of the Article. Whether a company is a permanent establishment of a related company, therefore, is based solely on those factors and not on the ownership or control relationship between the two.

Article 6. BUSINESS PROFITS

The location of this Article (and the articles on real property income and related persons) is different from the OECD Model and other U.S. treaties. Nothing substantive is intended by this ordering of the subject matter, which merely reflects the suggestion that it is more logical.

Article 6 provides the rules for the taxation by a Contracting State of the business profits of a resident of the other Contracting State. Currently, the rate of tax on profits in Kazakhstan is 30 percent, and the rate on corporate profits in the United States is 35 percent.

Paragraph 1 states the general rule that business profits (as defined in paragraph 6) of a resident of one Contracting State may not be taxed by the other Contracting State unless the resident carries on or has carried on business in the other Contracting State through a permanent establishment (as defined in Article 5 (Permanent Establishment)) situated in that other State. Where that condition is met, the other State may tax the business profits attributable to the assets or activity of the permanent establishment. The State in which the permanent establishment is situated may also tax the business profits derived from the sales in that State of goods or merchandise of the same kind as those sold through the permanent establishment and the business profits from the resident's other business activities in that State if the activities are the same kind as those performed through the permanent establishment. The latter rule derives from the U.N. Model and is similar to provisions that appear in the United States treaties with Mexico, Indonesia, and India. It amounts to a partial "force of attraction," by attributing to the permanent establishment sales of goods or performance of services by the home office if the goods or services are the same kind as those sold or performed, respectively, through the permanent establishment. This "force of attraction" attributes profits to the permanent establishment whether or not the assets and activities of the permanent establishment were involved in the sale or performance. Such a "force of attraction" rule is often requested by developing countries to prevent avoidance of their tax at source, although it is not the preferred U.S. position.

Paragraph 1 incorporates the rule of section 864 (c)(6) of the Code with respect to deferred payments. Thus, if income was attributable to a permanent establishment or fixed base when earned, it is taxable by the State where the permanent establishment or fixed base was located, even if receipt of the income is deferred until the permanent establishment or fixed base has ceased to exist. This same approach is reflected in the provisions of Articles 10 (Dividends), 11 (Interest), 12 (Royalties), and 14 (Independent Personal Services) dealing with amounts attributable to a permanent establishment or fixed base.

Paragraph 2 provides that the Contracting States will attribute to a permanent establishment the profits that it would be expected to make if it were an independent entity, engaged in the same or similar activities under the same or similar conditions. Profits so attributable to a permanent establishment are taxable in the State where the permanent establishment is situated or was situated at the time the profits were made.

The profits attributable to a permanent establishment may be from sources within or without a Contracting State. Thus, certain items of foreign source income described in section 864(c)(4)(B) or (C) of the Code may be attributed to a U.S. permanent establishment of a resident of Kazakhstan and be subject to tax in the United States. The concept of "attributable to" in the Convention is narrower than the concept of "effectively connected" in section 864(c) of the Code. The limited "force of attraction" rule in Code section 864(c)(3), therefore, is not applicable under the Convention to the extent it is broader than the rule of subparagraphs b) and c) of paragraph 1 of this Article.

Paragraph 3 provides that the tax base must be reduced by deductions for expenses incurred for the purposes of the permanent establishment. These include expenses directly incurred by the permanent establishment and a reasonable allocation of expenses, as long as the expenses were incurred on behalf of the resident's business enterprise as a whole or a part of it that includes the permanent establishment and as long as the expenses relate to the business activities of the resident. Allocable expenses would include executive and general administrative expenses, research and development expenses, interest, and charges for management, consultancy, or technical assistance, wherever incurred and without regard to whether they are actually reimbursed by the permanent establishment. The permanent establishment must be able to document such expenses, if so requested by the tax authorities of the State in which it is located.

To ensure continuous and consistent tax treatment, paragraph 3 also requires that the method for calculating the profits and losses of a permanent establishment be the same from year to year unless there is a good and sufficient reason to change the method. A taxpayer may not vary the method from year to year simply because a different method achieves a more favorable tax result.

Paragraph 3 also clarifies, as does the U.N. Model and the commentary to the OECD Model, that a permanent establishment may not take deductions for royalties, fees, commissions, or service fees paid to its home office or any other office of the resident. There was no intention, however, to deny deductions for such payments when they are made as reimbursement of actual expenses incurred by the home office or another office. The point of this provision is to clarify that, because the home office and the permanent establishment are parts of a single entity, there should be no profit element in intra-company transfers.

Point 8 b) of the Protocol ensures that Kazakhstan will permit a full deduction of interest expense in computing the profits of a U.S. resident's permanent establishment in Kazakhstan. Kazakhstan is not, however, required to allow a deduction for interest in excess of any limitation specified in Kazakh law, as long as that limit permits deduction of an arm's length interest rate, taking into account a reasonable risk premium.

Paragraph 4 provides that no business profits will be attributed to a permanent establishment because it purchases goods or merchandise for the enterprise of which it is a permanent establishment. This rule refers to a permanent establishment that performs more than one function for the enterprise, including purchasing. For example, the permanent establishment may purchase raw materials for the enterprise's manufacturing operation and may sell the manufactured output. While business profits may be attributable to the permanent establishment with respect to its sales activities, no profits are attributable with respect to its purchasing activities. If the sole activity were the purchasing of goods or merchandise for the enterprise, the issue of the attribution of income would not arise, because under subparagraph 4(d) of Article 5 (Permanent Establishment) there would be no permanent establishment.

Paragraph 5 of this Article applies where the information available either from the taxpayer or through competent authority is insufficient to calculate business profits under the other provisions of the Article. In particular, paragraph 5 applies where there is insufficient information concerning expenses. In that event, either Contracting State may apply its internal laws to determine the profits of the permanent establishment. These internal laws may make assumptions about expenses and thus may

estimate profits, rather than compute them with complete certainty.

The Memorandum of Understanding between the Contracting States makes clear that paragraph 5, and thus any internal law of either country that presumes expenses, may not be applied if books and records audited by a certified public accountant are available. In that case, the audited books and records will be considered adequate for calculating actual profits, and it will not be necessary--or permissible--to resort to presumptions. In addition, paragraph 5 itself provides that information will be considered readily obtainable by the competent authority if the taxpayer provides the information within 91 days of that competent authority's written request. This provision effectively establishes the procedure to be followed by a competent authority before it may invoke this paragraph to apply any internal law, and it ensures that the taxpayer is consulted and given an opportunity to cooperate.

Paragraph 6 illustrates the meaning of the term "business profits," as it is used in this Article. The term includes income from manufacturing, mercantile, transportation, communication, or extractive activities (including the operation of a mine), as well as income from the furnishing of the services of others. It does not include income from the rental of tangible personal property or income from the rental or licensing of cinematographic films or films or tapes used for radio or television broadcasting. Compensation received by an individual for his or her personal services, whether the individual is self-employed or an employee, is not within the scope of "business profits." Rather, that compensation is covered by Article 14 (Independent Personal Services) if the individual is self-employed or by Article 15 (Income from Employment) if the individual is an employee.

Paragraph 7 coordinates the provisions of this Article and other provisions of the Convention. Under paragraph 7, where business profits include items of income that are dealt with separately under other articles of the Convention, the provisions of those articles will, except where they specifically provide to the contrary, take precedence over the provisions of Article 6. Thus, for example, the taxation of interest will be determined by the rules of Article 11 (Interest) except where, as provided in paragraph 4 of Article 11, the interest is attributable to a permanent establishment, in which case the provisions of Article 6 will apply.

Article 7. ASSOCIATED ENTERPRISES

This Article allows the Contracting States to make appropriate adjustments to the taxable income and tax liability of related persons that engage in non-arm's length transactions

with one another. The Article provides that the States may make such adjustments as are necessary to reflect the income or tax that each party to the transaction would have had if the transaction had been at arm's length.

Paragraph 1 a) deals with the circumstance where a resident of a Contracting State participates, directly or indirectly, in the management, control, or capital of a resident of the other Contracting State, and paragraph 1 b) deals with a situation in which the same persons participate, directly or indirectly, in the management, control, or capital of a resident of one of the Contracting States and of any other person. The term "control" includes any kind of control, whether or not legally enforceable and however exercised or exercisable. If, in either of these related party cases, there are commercial or financial dealings that do not reflect arm's length terms or conditions, the competent authorities may adjust the income of their residents to reflect an arm's length transaction.

The adjustments allowed by the provisions of paragraph 1 can give rise to taxation of the same income by both Contracting States. To address this potential double taxation, paragraph 2 provides that, where a Contracting State has made an adjustment to the income of one of its residents to reflect arm's length terms, the other Contracting State will make a corresponding adjustment to the tax liability of a related person resident in that other State. It is understood that the other Contracting State need adjust its tax only if it agrees that the initial adjustment is appropriate. The other provisions of the Convention, where relevant, are to be taken into account. The competent authorities will consult, as necessary, in applying these provisions.

Paragraph 2 of Article 25 (Mutual Agreement Procedure) explains that the corresponding adjustment by the other Contracting State will not be prevented by a domestic statute of limitations or other procedural limitation. The "saving clause" of paragraph 3 of Article 1 (General Scope) does not apply to paragraph 2 of Article 25. (See Article 1 (4)(a).) Thus, even if the statute of limitations has run or if there is a closing agreement between the Internal Revenue Service and the taxpayer, a refund of tax may be required to implement a corresponding adjustment. Statutory or procedural limitations, however, cannot be overridden to impose additional tax because, under paragraph 2 of Article 1 (General Scope), the Convention cannot restrict any statutory benefit.

Paragraph 3 simply confirms this Article 7 does not restrict the application of either Contracting State's domestic laws that adjust the income of related persons. The reference in paragraph 1 to "income," for example, does not imply that adjustments may not relate to deductions, exemptions, credits, or other elements

affecting tax liability. Adjustments to the elements of tax liability are permitted even if they are different from, or go beyond, those authorized by paragraph 1 of this Article, as long as they accord with the general principles of paragraph 1, i.e., the adjustments reflect what would have transpired had the related parties been acting at arm's length.

Article 8. SHIPPING AND AIR TRANSPORT

This Article provides the rules that govern the taxation of income from the operation of ships and aircraft in international traffic. This Article, rather than Article 6 (Business Profits), applies even if a resident of one State has a permanent establishment in the other State to which profits from the operation of ships and aircraft in international traffic are attributable.

"International traffic" is defined in subparagraph 1 f) of Article 3 (General Definitions). Income from the operation of ships or aircraft in international traffic, when derived by a resident of either Contracting State, may be taxed only by that State, the country of residence. The other Contracting State must exempt the income from tax, even if the income arises in or is attributable to a permanent establishment in that State. The only circumstance in which the non-resident State may tax income from the operation of ships or airplanes is when the income arises from transport solely between places in that State (i.e., only when the income is not derived from operation in "international traffic" as defined in paragraph 1 f) of Article 3).

Income from the rental of ships or planes on a full basis for use in international traffic is considered operating income and is taxable only in the country of residence. Income from the bareboat leasing of ships or planes is also exempt from tax at source if the ship or aircraft is used in international traffic by the lessee. In such a case, it does not matter whether the lessor carries on a business of operating ships or planes; the rule applies even to a leasing company. However, if the lessor is an operating company, and the income is incidental to income from such operations, the exemption from source State taxation extends also to income from the rental of ships or aircraft used in domestic traffic by the lessee. Income from the leasing or use of containers in international traffic is also exempt from tax at source under this Article, whether derived by an operating company or by a leasing company.

Paragraph 3 clarifies that the provisions of paragraphs 1 and 2 apply to income from participation in a pool, joint business, or international transportation agency. For example, if a Kazakh airline were to form a consortium with other national

airlines, the Kazakh participant's share of the income derived from U.S. sources would be covered by this Article.

Article 9. INCOME FROM REAL PROPERTY

Paragraph 1 provides the standard income tax treaty rule that income derived by a resident of a Contracting State from real property, including income from agriculture or forestry, located in the other Contracting State, may be taxed in that other State. The income may also be taxed in the state of residence.

Paragraph 2 defines real property in accordance with the laws of the Contracting States, but provides that it includes, in any case, any interest in land, unsevered products of land, and structures on the land, and excludes boats, ships, and airplanes.

Paragraph 3 clarifies that the Article covers income from any use of real property, without regard to the form of use or lease.

Paragraph 4 provides for a binding election by the taxpayer to be taxed on a net basis. The election is based on U.S. treaty policy and reflects U.S. law. Because this Article provides for net basis taxation, it generally provides the same tax result as Article 6 (Business Profits).

Article 10. DIVIDENDS

This Article provides rules for limiting the taxation at source of dividends paid by a company that is a resident of one Contracting State to a shareholder who is a resident of the other Contracting State. It also provides rules for the imposition of a tax at source on branch profits, analogous to the tax on dividends paid by a subsidiary to its parent company. Notwithstanding the source State's treaty obligation to limit the rate of tax it applies to dividends, that State may, in accordance with point 4 of the Protocol, withhold on dividends at the applicable domestic rates, as long as the State timely refunds any excess amount withheld over the maximum rates established by the treaty.

Paragraph 1 of Article 10 preserves the general right of a Contracting State to tax its residents on dividends received from a company that is a resident of the other Contracting State. The same result is achieved by the saving clause of paragraph 3 of Article 1 (General Scope).

Except as otherwise provided in paragraph 4 and in point 2 of the Protocol (discussed below), paragraph 2 also permits the source State to tax a dividend but limits the rate of source State tax that may be imposed on dividends paid to a resident of

the other State. When the beneficial owner of the dividend is a company resident in the other State that owns at least 10 percent of the voting stock of the paying corporation, the maximum source rate is 5 percent. In other cases, the source State tax is limited to 15 percent of dividends beneficially owned by residents of the other State.

Paragraph 3 defines the term "dividends" as used in this Article. The term encompasses income from any shares or rights that are not debt claims and that participate in profits. It also includes income from other corporate rights treated for domestic law tax purposes as dividends in the country of residence of the distributing company and income from other arrangements, even debt claims, if such arrangements carry the right to participate in profits and the income is characterized as a dividend under the domestic law of the country of residence of the distributing company. The last case takes into account domestic law distinctions between debt and equity. The definition of dividends in this Article also confirms that distributions by a Kazakhstan joint venture to the venturer's foreign participants are dividends for purposes of this Article. Thus, such distributions are eligible for the reduced tax rates specified in paragraph 2.

Paragraph 4 explains that, where dividends are attributable to a permanent establishment or fixed base that the beneficial owner maintains in the other State, they are not subject to the provisions of paragraphs 1 and 2 of this Article, but are covered by Article 6 (Business Profits) or Article 14 (Independent Personal Services), as appropriate. This is also the case if the permanent establishment or fixed base has ceased to exist when the dividends are received as long as the dividends are attributable to a permanent establishment or fixed base that did exist in an earlier year.

Paragraph 5 permits a Contracting State to impose a branch profits tax on a corporation that is a resident of the other State. The tax is in addition to the ordinary tax on business profits and may be applied not only where there is a permanent establishment but also where the source State applies a net basis tax in accordance with other articles of the Convention. The additional tax is imposed on the "dividend equivalent amount" of profits, at the 5 percent rate that would apply to dividends paid by a wholly-owned subsidiary corporation to its parent. The U.S. tax will be imposed in accordance with section 884 of the Internal Revenue Code, or a successor statute, subject to the reduced rate provided for in this Article. Point 2 b) of the Protocol explains the meaning of the term "dividend equivalent amount," and, in the case of the United States, defines the term consistently with U.S. law. Kazakhstan's new tax law, enacted by presidential decree on April 24, 1995, imposes a branch tax at

the rate of 15 percent, which will be reduced by the treaty to 5 percent.

Paragraph 2 a) of the Protocol also relaxes the limitations on source country taxation for dividends paid by a U.S. Regulated Investment Company (RIC) or a Real Estate Investment Trust (REIT). A dividend paid by a RIC is subject to the 15-percent portfolio dividend rate regardless of the percentage of voting shares of the RIC held by the recipient of the dividend. The 5-percent direct investment rate is intended to relieve multiple levels of corporate taxation. A RIC, however, pays no corporate-level tax on income it distributes to shareholders, and, to maintain its tax-favored status, RICs typically do distribute substantially all of their income. There is, therefore, effectively, no corporate-level RIC tax; the shareholder-level tax is the only U.S. tax imposed on the RIC's income. Moreover, a foreign shareholder could own a 10 percent interest in a RIC without owning a 10 percent interest in the companies whose shares are held by the RIC, effectively converting a portfolio dividend into a direct investment dividend without incurring any additional tax.

In the case of a dividend paid by a REIT, the treaty does not limit the rate of tax that may be applied. Thus, in the case of the United States, a 30 percent tax will apply to REIT distributions. In some other recent U.S. treaties, the tax on REIT dividends is limited to the 15-percent portfolio dividend rate for certain individual shareholders presumed to be in the lowest bracket of the U.S. individual income tax. In this Convention, however, the single statutory rate of 30 percent will apply to all REIT dividends.

Article 11. INTEREST

This Article governs the taxation of interest. The ability of the residence State to tax interest is provided by paragraph 1 and also preserved by the saving clause of paragraph 3 of Article 1 (General Scope). Interest derived from one Contracting State and beneficially owned by a resident of the other State may also be taxed by the first (source) State. However, as provided in paragraph 2, the tax imposed by the source State may not exceed 10 percent. This reduced rate does not apply to back-to-back loans. Notwithstanding its treaty obligation to limit the rate of tax applied to interest, the source State may, in accordance with point 4 of the Protocol, withhold on interest at its domestic rates, as long as it timely refunds any excess amount withheld over the maximum rates established by the treaty.

In the absence of the Convention, Kazakhstan's withholding rate on interest paid to a U.S. resident (and not attributable to a permanent establishment of that resident in Kazakhstan) would

be 15 percent. The general U.S. statutory rate on payments of interest to nonresidents is 30 percent, with an exemption for portfolio interest.

The preferred U.S. treaty policy is source country exemption of interest paid to a resident of the other country. This policy coincides with U.S. internal law, which generally exempts interest paid to nonresidents from U.S. tax. It is not uncommon, however, particularly in treaties with developing countries, for the United States to agree to some source country tax. Point 3 a) of the Protocol provides that, if Kazakhstan agrees in a treaty between it and another country that is a member of the OECD to impose a rate at source on interest lower than the 10 percent provided for in this Convention, this Convention will be promptly amended to incorporate that lower rate. The amended Convention would then be submitted to the United States Senate for its acceptance of the lower rate (see also, point 4 of the Memorandum of Understanding).

As the term "interest" is not specifically defined in the Convention, its meaning depends upon the domestic law of the State whose tax is being applied (see paragraph 2 of Article 3 (General Definitions)). The term is used in the Convention in the usual sense to refer to income from debt claims of every kind other than those giving rise to dividends under paragraph 3 of Article 10 (Dividends). Penalties and fines for late payment are generally not included in the treaty concept of interest; such amounts may be imposed in accordance with domestic law.

Paragraph 3 specifies two categories of interest that, notwithstanding the provisions of paragraph 2, are exempt from tax at source when the beneficial owner is a resident of the other State. Those categories are: (i) interest paid or beneficially owned by either Contracting State or any political subdivision or local authority thereof or any government instrumentality agreed upon by the competent authorities, and (ii) interest on loans of three years or longer that are made, guaranteed, or insured by a specified public lending institution. Point 3 b) of the Protocol provides that the lending institutions to which loans in (ii) will apply are the Export-Import Bank, the Overseas Private Investment Corporation of the United States, and any other similar agencies that are agreed upon in the future by the competent authorities. Point 3 b) of the Protocol further provides that there will be no required exemption for loans made or guaranteed by these institutions if the lender has a right of recourse against any person other than the borrower or a governmental body in the borrower's country. This Point arose from Kazakhstan's view that the exemption should not cover internal group financing or loans to joint ventures in which there are other foreign participants besides the U.S. venturers.

Paragraph 4 provides an exception from the rules of paragraphs 1, 2, and 3 in cases where the beneficial owner of the interest, a resident of one Contracting State, carries on business through a permanent establishment in the other Contracting State or performs independent personal services through a fixed base situated in that other State and the interest is attributable to that permanent establishment or fixed base. In such a case, the income is taxable to the permanent establishment or fixed base in accordance with the provisions of Article 6 (Business Profits) or Article 14 (Independent Personal Services). This rule applies even if the permanent establishment or fixed base no longer exists when the interest is received or accrued, as long as the interest would have been attributable to the permanent establishment or fixed base if it had been paid or accrued in the earlier year.

Paragraph 5 provides a source rule. Interest is considered to arise in a Contracting State if paid by a resident of that State (including the State itself). In addition, interest paid by any person (whether or not a resident) and borne by a permanent establishment or fixed base or other activity giving rise to income subject to tax on a net basis in the non-residence State under the Convention (e.g., income from real property under Article 9, certain royalty income under paragraphs 2 and 3 b) of Article 12, and gains under paragraph 1 or 2 of Article 13) is considered to arise in that State. For this purpose, interest is considered to be "borne by" a permanent establishment, fixed base, or other trade or business if it is allocable to (whether or not deductible from) taxable income of that permanent establishment, fixed base, or trade or business. If the actual amount of interest on the books of a U.S. branch of a Kazakh business exceeds the amount of interest allocated to the branch under Treas. Reg. § 1.882-5, any such interest will not be considered U.S. source interest for purposes of this Article. Conversely, the total amount of interest allocated to the branch under that regulation will be U.S. source even if the amount exceeds branch book interest.

The source rules in paragraph 5, as applied to interest paid by Kazakh corporations conducting business in the United States through a permanent establishment or fixed base, are consistent with the rules contained in Treas. Reg. § 1.884-4, which treat interest allocable to the U.S. trade or business of a foreign corporation under Treas. Reg. § 1.882-5 as if such interest were paid by a domestic corporation and, thus, sourced in the United States. The presence of this source rule confirms that interest paid by a U.S. permanent establishment of a Kazakh corporation, within the meaning of section 884(f)(1)(A) of the Code, is subject to a 10 percent rate of tax pursuant to paragraph 2 where such interest is paid to a resident of Kazakhstan.

Paragraph 6 provides that if, as a result of a special relationship between persons, the amount of interest paid is excessive, Article 11 will apply only to the amount of interest payments that would have been made absent such special relationship (i.e., an arm's length interest payment). Any excess amount of interest paid remains taxable according to the domestic law of the source State, with due regard to the other provisions of the Convention. Thus, for example, if the excess amount would be treated as a distribution of profits, such amount could be taxed as a dividend rather than as interest, but the tax would be subject, if appropriate, to the rate limitations of paragraph 2 of Article 10 (Dividends).

Point 3 c) of the Protocol reserves the right of the United States to tax an excess inclusion of a residual holder of a Real Estate Mortgage Investment Conduit (REMIC) in accordance with U.S. domestic law; thus, the tax on such an excess inclusion of a resident of Kazakhstan would be subject to the domestic rate of withholding tax, now 30 percent.

Paragraph 7 clarifies that the United States may also impose a tax on the "excess interest amount" of a Kazakh resident that conducts business in the United States through a permanent establishment or fixed base or derives income in the United States that is otherwise subject to tax on a net basis under the Convention. Paragraph 7 limits the rate of such tax, however, to not more than 10 percent of the "excess interest amount." This is the same rate that applies to interest under paragraph 2.

The "excess interest amount" is defined in point 3 d) of the Protocol to coincide with the provisions of Code section 884(f)(1)(B). Accordingly, the United States may apply its tax on excess interest (but at the lowered treaty rate) to the excess, if any, of (i) interest borne by a U.S. permanent establishment, fixed base, or other trade or business of a Kazakhstan resident subject to tax on a net basis over (ii) the interest paid by such permanent establishment, fixed base, or trade or business. (The interest would be U.S. source under paragraph 5 because it is borne by a U.S. branch.) Under current U.S. law, the excess amount is deemed paid by a U.S. corporation to a Kazakhstan corporation. Moreover, current U.S. law imposes branch level interest taxes only on foreign corporations and not on non-corporate foreign residents. Interest will be considered "borne by" a permanent establishment even if the interest is not fully deductible in that year, provided it is allocable in that year to the permanent establishment's U.S. income under U.S. domestic rules.

Unlike the United States, Kazakhstan does not currently impose a tax on excess interest comparable to the U.S. tax on excess interest. The provisions permitting application of a tax on an excess interest amount, however, are drafted reciprocally.

Should Kazakhstan enact a tax on excess interest, the "excess interest amount" to which it could apply that tax would be limited to the amount of interest deductible in computing the profits of a Kazakh branch of a U.S. resident, provided the amount were similar to the amount that would be "excess interest" under U.S. law.

Article 12. ROYALTIES

This Article limits the taxation at source by each Contracting State of royalties paid to a resident of the other Contracting State.

Paragraph 1 preserves the residence State's general right to tax its residents on royalties arising in the other Contracting State. The same result is achieved by the saving clause of paragraph 3 of Article 1 (General Scope).

Paragraph 2 permits the source State to tax royalties but limits the rate of source State tax to 10 percent of the gross amount of royalties beneficially owned by residents of the other State. Notwithstanding its treaty obligation to limit the rate of tax applied to royalties, the source State may, in accordance with point 4 of the Protocol, withhold on royalties at its domestic rates, as long as it timely refunds any excess amount withheld over the maximum rates established by the treaty.

As defined in paragraph 3, the term "royalties" includes payments for equipment rentals. (Payments for the rental of ships, aircraft, and containers in connection with international traffic, however, are covered by Article 8 (Shipping and Air Transport).) Paragraph 2 provides that the beneficial owner of royalties arising from equipment rentals may elect to compute the source State tax on a net basis, as if the royalties were attributable to a permanent establishment or fixed base. In that case, the 10 percent maximum rate of paragraph 2, which limits any gross basis tax, will not be applicable. The election effectively treats income from the leasing of equipment as if it were attributable to a permanent establishment in the source State and covered by Article 6 (Business Profits). The preferred U.S. position is in fact to treat income from the rental of tangible personal property under Article 6. A beneficial owner of the payments from equipment rentals that makes the net election may, in addition to the source State tax on profits, be subject to any source State branch taxes under paragraph 5 of Article 10 (Dividends) or paragraph 7 of Article 11 (Interest).

Paragraph 2 further defines the term "royalties" as used in the Convention to mean payments of any kind received as a consideration for the use of, or the right to use, any copyright of a literary, artistic, or scientific work, including computer software programs, video cassettes, and films and tapes for radio

and television broadcasting. The term also includes payments for the use of, or right to use, any patent, trademark, design or model, plan, secret formula or process, or other like right or property; or for information concerning industrial, commercial, or scientific experience. The term "information concerning industrial, commercial, or scientific experience" alludes to the concept of "know-how" and means information that is not publicly available and that cannot be known from mere examination of a product and mere knowledge of the progress of technique. As provided in the Commentaries to the OECD Model (Paragraph 11 of the Article 12 Commentaries), "In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public." This distinguishes the "know-how" contract from a contract for the provision of services or technical assistance, in which one party agrees himself to perform work for the other party.

Paragraph 4 provides an exception to the rules of paragraphs 1 and 2 in cases where royalties are attributable to a permanent establishment or fixed base that the beneficial owner, a resident of one Contracting State, has in the other Contracting State. In such a case, the royalties are taxable to the permanent establishment or fixed base in accordance with the provisions of Article 6 (Business Profits) or Article 14 (Independent Personal Services). The same rule applies if the permanent establishment or fixed base has ceased to exist when the royalties are received, so long as the royalties would have been attributable to it if they had been paid or accrued in the earlier year.

Paragraph 5 provides a source rule for royalties that reflects the U.S. rule. That is, royalties will be deemed to arise in a Contracting State, and thus may be taxed there in accordance with the provisions of paragraph 2, if they are paid for the use or right to use in that State property giving rise to the royalty.

Paragraph 6 provides that if, as a result of a special relationship between persons, the royalty paid is excessive, Article 12 will apply only to the amount of royalty payments that would have been made absent such special relationship (*i.e.*, an arm's length royalty payment). Any excess amount of royalties paid remains taxable according to the laws of the United States and Kazakhstan, respectively, with due regard to the other provisions of the Convention. If, for example, the excess amount is treated as a distribution of profits, such excess amount could be taxed as a dividend rather than as a royalty payment, but the tax imposed on the dividend payment would be subject, if appropriate, to the rate limitations of paragraph 2 of Article 10 (Dividends).

Article 13. GAINS

This Article provides rules governing when a Contracting State may tax capital gains derived by a resident of the other Contracting State.

Paragraph 1 provides that each State may tax gains on the alienation of real property situated in that State. The Convention does not interfere with the domestic law rules on the taxation of such gains, other than to require non-discriminatory treatment under Article 24 (Non-discrimination).

Paragraph 2 elaborates, in effect, on the rule of paragraph 1 by permitting each State to tax gains from the alienation of real property held not only directly but also indirectly through a corporation, partnership, trust, estate, or other legal person. Thus, to the extent the property of a corporation or other legal person consists principally of real property situated in a Contracting State, gain on the alienation of an interest in that corporation or other person may be taxable by that State. This is true whether or not the corporation or other legal person is itself resident of that State. Subparagraph b) of paragraph 2 provides similar treatment for gain on the alienation of an interest in a partnership, trust, or estate (again, whether or not it is a resident of a Contracting State) to the extent the gain is attributable to real property situated in a Contracting State. The term "real property" for purposes of paragraph 2 includes the shares of any company and the interest in any partnership, trust, or estate referred to in the paragraph. It also specifically includes a "United States real property interest" as defined in Code section 897 or any successor to that provision.

Paragraph 3 provides a rule similar to provisions in the United States treaties with Spain and Mexico. It permits a Contracting State to tax the gain derived by a resident of the other State on the disposition of shares or other rights in the capital of a corporation or other legal person resident in the first State. The right to impose this tax, however, is permitted only if the person disposing of the shares has or had at any time during the 12-month period preceding the disposition a direct or indirect interest of at least 25 percent in the vote or value of the corporation or other legal person. At present, neither the United States nor Kazakhstan imposes a tax on the alienation by a nonresident of shares in a local corporation or other legal person. This paragraph, therefore, currently has no practical effect. Point 6 of the Protocol provides that, in the event either State introduces such a tax in the future, it must inform the other State in a timely manner and must consult with that other State with a view to providing for nonrecognition treatment in appropriate cases. The cases envisioned were those involving corporate reorganizations and other intercompany transfers. The negotiators believed it prudent to postpone consideration of nonrecognition provisions until such time as actual laws make

clearer what exceptions and allowances are necessary. Moreover, views within each Contracting State on the types of transactions that are appropriately excepted from current taxation may change. Thus, elaborate nonrecognition provisions of the type that appear in the United States treaties with Spain and Mexico are not provided in the present agreement, but the Convention does impose a good faith obligation to craft such exceptions in the event domestic laws change. It is expected that the corresponding provisions in the treaties with Mexico and Spain will serve as guidance in the crafting of exceptions in this Convention.

To the extent one State does tax the share gains of residents of the other State as permitted by paragraph 3, the residence State will source the gains in the non-residence State to the extent necessary to permit a foreign tax credit or otherwise avoid double taxation.

Paragraph 4 provides that gain from the alienation of personal property attributable to a permanent establishment or fixed base that a resident of one Contracting State has in the other Contracting State may be taxed by that other State. Gain from the alienation of personal property comprising part or all of the assets of the permanent establishment or fixed base also may be taxed by that other State. Paragraph 4 does not permit the United States to impose tax under Code section 864(c)(7) with respect to gain from the subsequent disposition of assets that were formerly used in connection with a U.S. permanent establishment or fixed base. Kazakhstan does not tax gain in such circumstances.

Paragraph 5 provides that gains derived by a resident of one of the Contracting States from the alienation of ships, aircraft, containers, or related equipment operated in international traffic may be taxed only by that State. Occasional use of a ship, aircraft, container, or related equipment in domestic traffic should not cause the disposition of such property to fall outside the scope of this provision.

Paragraph 6 reserves the exclusive right to tax gains with respect to any property not specified in the previous paragraphs of this Article to the State in which the alienator is a resident.

Article 14. INDEPENDENT PERSONAL SERVICES

The Convention deals in separate articles with different classes of income from personal services. Article 14 deals with the general class of income from independent personal services, and Article 15 deals with the general class of income from employment, sometimes referred to as dependent personal services. Articles 16 through 19 provide exceptions and additions to these general rules for directors' fees (Article 16); government

service salaries (Article 17); pensions and social security benefits (Article 18); and certain income of students, trainees and researchers (Article 19).

Unlike the OECD Model and certain other U.S. treaties, this Convention does not provide a separate article dealing with entertainers and athletes. Like the OECD Model and other U.S. treaties, the Convention does not provide a separate rule for the remuneration of teachers. (See the discussion under Article 19 (Students, Trainees, and Researchers.)) The compensation of such individuals is taxable under this Article or Article 15 (Income from Employment).

Income derived by an individual who is a resident of one Contracting State from the performance of personal services in an independent capacity is exempt from tax in that other State unless one of two conditions is met. The income may be taxed in that other State if the services are or were performed there (see Code section 864(c)(6)) and if the income is attributable to a fixed base that the individual regularly used or uses in that other State in performing services. Alternatively, if the individual is or was present in that other State for more than an aggregate of 183 days in any twelve month period beginning or ending in the taxable year concerned, that other State may tax the income attributable to the activities performed there, whether or not there is a fixed base. Under either the fixed base or 183 day presence test, it is understood that the taxation of income from independent personal services is to be governed by the principles set forth in Article 6 (Business Profits). In particular, the income attributed to the services must be taxed on a net basis, after allowance of deductions for business expenses, in accordance with principles similar to those provided in Article 6 for the taxation of business profits of a permanent establishment. However, the nonresident State may only tax income that is attributed to services performed in that State and may not in any case tax income from services performed elsewhere.

Paragraph 2 notes that the term "independent personal services" includes independent scientific, literary, artistic, educational or teaching activities, as well as the independent activities of physicians, lawyers, engineers, architects, dentists, and accountants. This list, which is derived from the OECD Model, is not exhaustive. The term includes all personal services performed by an individual for his own account, where he receives the income and bears the risk of loss arising from the services.

Article 15. INCOME FROM EMPLOYMENT

This Article deals with the taxation of remuneration derived by a resident of a Contracting State from the performance of personal services as an employee. Paragraph 1 also provides that the more specific rules of Articles 16 (Directors' Fees), 17 (Government Service), and 18 (Pensions, Etc.) apply in the case of employment income described in one of those articles. Thus, even though the State of source has a right to tax employment income generally under Article 15, it may not have the right to tax a particular type of income under the Convention if that right is proscribed by one of the aforementioned articles. Similarly, these other articles may expand the source State's right to tax beyond the circumstances in which Article 15 would permit it to tax.

Under paragraph 1, remuneration derived by an employee who is a resident of a Contracting State may be taxed by his State of residence. This is the same result achieved by the saving clause of paragraph 3 of Article 1 (General Scope). Under paragraph 2, the remuneration also may be taxed by the other Contracting State if the remuneration is derived from the performance of services in that other State and if one of the following is true: (1) the individual is present in that other State for a period or periods exceeding in the aggregate 183 days in any twelve month period beginning or ending in the taxable year concerned; (2) the remuneration is paid by, or on behalf of an employer who is a resident of that other State; or (3) the remuneration is borne as a deductible (or capitalizable) expense by a permanent establishment or fixed base that the employer has in that other State. If a foreign employer pays the salary of an employee, but a host country corporation or permanent establishment reimburses the foreign employer in a deductible payment that can be identified as a reimbursement, either condition (2) or (3), as the case may be, will be considered to have been fulfilled. Conditions (2) and (3) are intended to ensure that a Contracting State will not be required both to allow a deduction to the payor for the amount paid and to exempt the employee on the amount received. Failure to satisfy any of the three conditions will result in exclusive residence State taxation of employment income.

Paragraph 3 contains a special rule exempting income from tax at source in one particular case. That case involves remuneration for services performed as an employee aboard a ship or aircraft operated in international traffic.

Article 16. DIRECTORS' FEES

This Article provides that a Contracting State may tax the fees paid by a company which is a resident of that State for services performed by a resident of the other Contracting State in his or her capacity as a director of the company. For this purpose, "similar payments" includes fixed salaries (or the

portion thereof) paid for services performed as a director (not to include any portion of such salary paid for performance as an officer).

Article 17. GOVERNMENT SERVICE

This Article follows the corresponding provisions of the OECD Model.

Paragraph 1 provides that generally payments from the public funds of a Contracting State or political subdivision or local authority to compensate an individual for performing governmental services may be taxed only by that State. However, if the services are rendered in the other State by an individual who is either a citizen of that other State, or was a resident of that other State prior to taking the governmental job (or otherwise did not become a resident of the other State solely for the purpose of taking the job), the compensation may be taxed only by that other State. It is understood that a governmental worker's spouse who takes a governmental job subsequent to becoming a resident of the host state nevertheless will be considered to have become a resident of the host State solely for the purpose of taking a governmental job.

The rules of paragraph 1 are an exception to the saving clause of paragraph 3 of Article 1 (General Scope) for individuals who are neither citizens nor permanent residents of the State where the services are performed. Thus, for example, payments by Kazakhstan to its employees at the Kazakh Embassy in Washington, D.C. are exempt from U.S. tax if the employees are not U.S. citizens or green card holders and were not residents of the United States at the time they became employed by Kazakhstan, even if they would otherwise be considered U.S. residents for tax purposes. (Under the 1984 modification to the definition of a U.S. resident in Code section 7701, this exception to the saving clause is of less relevance, because time spent in the United States as a foreign government employee does not count in applying the physical presence test of residence.)

Paragraph 2 provides that this Article applies only to remuneration paid in respect of services of a governmental nature. Remuneration paid in respect of services for a government-conducted business (for example, a government-operated airline) are covered by Articles 14 (Independent Personal Services) or 15 (Income from Employment), as appropriate.

This Article does not cover pensions paid to individuals in respect of services rendered to the government of one of the Contracting States. Such payments are covered instead in Article 18 (Pensions, Etc.).

Article 18. PENSIONS, ETC.

The general rule of this Article is that pensions and similar remuneration in consideration of past employment may be taxed only by the Contracting State of which the beneficial owner is a resident. It is understood that the services need not have been performed by the beneficial owner of the pension; for example, a pension paid to a surviving spouse who is a resident of Kazakhstan would be exempt from taxation by the United States on the same basis as if the right to the pension had been earned directly by the surviving spouse. A pension may be paid in installments or in a lump sum.

Subparagraph b) of paragraph 1 provides the first exception to the general rule, that social security benefits and other public pensions paid by a Contracting State may be taxed only by that State. (This rule is also an exception to the saving clause of paragraph 3 of Article 1 (General Scope).) Thus, a Kazakh social security benefit will be exempt from U.S. tax even if the beneficiary is a U.S. resident or a U.S. citizen (whether resident in the United States, Kazakhstan, or a third country).

Paragraph 2 provides rules for the taxation of pensions paid from public funds in respect of governmental services. Such pensions may be taxed only by the paying State unless the individual is a resident and citizen of the other State, in which case only the other (residence) State may tax the pension. The rules of paragraph 2 do not apply to social security benefits and other public pensions which are not in respect of services rendered to the paying government or a political subdivision or local authority thereof; such amounts are taxed exclusively by the source State under the terms of paragraph 1 b). However, paragraph 2, in particular subparagraph b), does apply to social security payments to U.S. Government employees for whom the social security system is the retirement plan related to their government service. Thus, in the unusual case where a Kazakh citizen and resident derives a pension for U.S. Government employment that is paid under the social security system, only Kazakhstan may tax that pension, as provided by paragraph 2 b). This could happen, for example, if a locally hired driver for the U.S. Embassy in Almaty were to retire and receive a U.S. pension under social security.

Annuities derived and beneficially owned by an individual resident of a Contracting State may be taxed only by that State. This provision is intended to cover traditional annuity arrangements that provide retirement benefits to individuals. It is not intended to exempt from tax at source income from arrangements that are a variation of traditional annuities and that accrues to corporations or other legal persons.

Paragraph 4 provides for exclusive residence State taxation of alimony payments. The term "alimony" is defined by paragraph 4 to mean periodic payments made pursuant to a written separation

agreement or decree of divorce, separate maintenance, or compulsory support, which payments are taxable to the recipient under the laws of the State of residence. Under U.S. law, alimony payments are taxable to the recipient (and deductible by the payer). Kazakhstan does not tax the recipient of alimony (nor does it permit a deduction by the payer). In general, "alimony" payments are made in Kazakhstan solely for the support of children, and there is no concept of payments made solely for the support of a spouse or former spouse.

Paragraph 5 addresses child support payments and provides for exclusive source State taxation. Thus, when a resident pays child support to a resident of the other State, only the first-mentioned State may tax the payment. This rule is an exception to the saving clause of paragraph 3 of Article 1 (General Scope). Thus, a U.S. resident deriving child support payments from a resident of Kazakhstan will be exempt from any U.S. tax on those payments. Under the laws of both the United States and Kazakhstan, child support payments are not taxable to the recipient in any case (and are not deductible by the payer).

Article 19. STUDENTS, TRAINEES AND RESEARCHERS

This Article deals with visiting students, trainees, and, researchers. An individual who is a resident of one of the Contracting States and who visits the other Contracting State for the primary purpose of studying at an accredited educational institution, such as a university, or of studying or doing research as the recipient of a grant or similar payment from a charitable organization, or of acquiring training for a profession will not be taxed by the host State on amounts received from abroad to cover his expenses and on any grant or similar payment regardless of its source.

The reference to "primary purpose" is meant to describe individuals participating in a full-time program of study, training, or research. It was substituted for the reference in the OECD Model to "exclusive purpose" to prevent too narrow an interpretation; it is not the intention to exclude from the coverage of this paragraph full-time students who, in accordance with their visas, may hold part-time employment. For U.S. purposes, a religious, charitable, etc. organization as described in paragraph 1 c) means an organization that qualifies as tax-exempt under Code section 501(c)(3).

The exemptions provided in paragraph 1 are available for the period of time ordinarily necessary to complete the study, training, or research but not for more than five years in the case of training or research. It is expected that in most cases study programs would also be completed within five years; however, an individual who completes both undergraduate and

graduate degrees in the host State could require a longer period.

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

This Article is an exception to the saving clause of paragraph 3 of Article 1 (General Scope). Thus, a Kazakh student, trainee, or researcher is entitled to the benefits of this Article even if such individual becomes a resident of the United States under the substantial presence test of Code section 7701(b). However, the benefits of this Article are not available to a U.S. citizen or green card holder.

Article 20. OTHER INCOME

This Article provides the rules for the taxation of items of income derived by a resident of a Contracting State and arising in the other Contracting State that are not dealt with in the other articles of the Convention. Such income includes lottery winnings, punitive damages, and cancellation of indebtedness income. Such income may be taxed in the State in which it arises. Income arising in a third State is not dealt with in this Article. Thus, domestic laws apply, unless the income constitutes business profits of a permanent establishment or fixed base of a resident of the other Contracting State, in which case Article 6 (Business Profits) or 14 (Independent Personal Services) applies.

Article 21. LIMITATION ON BENEFITS

Article 21 addresses the problem of "treaty shopping" by assuring that source basis tax benefits granted by a Contracting State pursuant to the Convention are limited to the intended beneficiaries -- residents of the other Contracting State -- and are not extended to residents of third States not having a substantial presence in, or business nexus with, the other Contracting State. In a typical case of treaty shopping, 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. Article 21 limits the abuse of the Convention by limiting the benefits of the Convention to those persons whose residence in a Contracting State is not considered to have been motivated by the existence of the Convention.

Absent Article 21, 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) applicable to a particular transaction or arrangement. Article 21 and general anti-abuse provisions complement each other, as Article 21 generally determines whether an entity has a sufficient nexus to the Contracting State to be treated as a resident for treaty purposes, while general anti-abuse provisions determine whether a particular transaction should be recast in accordance with the substance of the transaction.

Article 21 follows the form used in other recent U.S. income tax treaties. See, e.g., the Convention between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes. The structure of the Article is as follows: Paragraph 1 lists a series of attributes of a resident of a Contracting State, the presence of any one of which will entitle that person to benefits of the Convention in the other Contracting State. Paragraph 2 provides that benefits also may be granted to a person not entitled to benefits under the tests of paragraph 1, if the competent authority of the source State determines that it is appropriate to provide benefits in that case. Paragraph 3 defines the term "gross income" as used in paragraph 1(e)(ii).

The first category of persons eligible for benefits from the other Contracting State under paragraph 1 consists of individual residents of a Contracting State. It is unlikely that individuals can be used to derive treaty-benefitted income on behalf of a third-country resident. If such an individual is receiving income as a nominee on behalf of a third country resident, benefits will be denied under the respective articles of the Convention by the requirement that the beneficial owner of the income be a resident of a Contracting State.

The second category consists of active businesses that are residents of one of the Contracting States and derive income from the other Contracting State that is connected with, or incidental to, that business. For this purpose, the business of making or managing investments is not considered an active business unless carried on by a bank or insurance company. 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 covered by subparagraph (b).

The third category, in subparagraph (c), consists of companies whose shares are regularly traded in substantial volume on an officially recognized securities exchange, or a company

wholly owned, directly or indirectly, by a company that is a resident of the same State and whose shares are so traded. Point 7 of the Protocol specifies that the term "officially recognized securities exchange" means, in the case of the United States, the NASDAQ System owned by the National Association of Securities Dealers, Inc., and any stock exchange registered with the Securities Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934. The Memorandum of Understanding between the two States provides that any other exchange will be treated as an "officially recognized exchange" under subparagraph (c) only if it is officially recognized by either State and agreed upon by the competent authorities of both States. This clarifies that point 7 neither limits the U.S. exchanges that may be "officially recognized" under paragraph 1 (c) to those specified in the Protocol nor implies that any exchange recognized by Kazakhstan is automatically within subparagraph (c). Thus, any future exchange officially recognized by Kazakhstan will be reviewed by the competent authorities and, only if they agree that it provides adequate requirements for listing and trading, will be treated as an "officially recognized exchange" for purposes of granting treaty benefits to companies listed and traded on it.

The fourth category covers tax-exempt organizations. If more than half of its beneficiaries, members, or participants (if any) are individual residents of either Contracting State or persons who meet the other criteria of this Article, the tax-exempt organization will be a qualified resident.

The fifth category provides a two-part test, the so-called ownership and base erosion tests. Both must be satisfied for the resident to be entitled to benefits under subparagraph (e). The ownership test requires that more than 50 percent of the beneficial interest in the person (or, in the case of a corporation, more than 50 percent of each class of its shares) be owned, directly or indirectly, by persons who are themselves entitled to benefits under the other tests of paragraph 1 (other than subparagraph (b)). The base erosion test requires that not more than 50 percent of the person's gross income be used, directly or indirectly, to meet liabilities to persons other than persons eligible for benefits under the other tests of paragraph 1 (other than subparagraph (b)). For this purpose "gross income" means gross receipts or, in the case of a manufacturing or producing activity, gross receipts less the direct costs of labor and materials. (See paragraph 3.)

The rationale for this two-part test is that, to prevent treaty benefits from inuring substantially to third-country residents, it is not sufficient to require substantial ownership of the equity of the entity by treaty country residents. It is also necessary to ensure that the entity's tax base not be eroded by deductible payments to third country residents.

It is intended that the provisions of paragraph 1 will be self-executing. Unlike the provisions of paragraph 2, discussed below, claiming benefits under paragraph 1 does not require advance competent authority ruling or approval. The tax authorities may, of course, on review, determine that the taxpayer has improperly interpreted the paragraph and is not entitled to the benefits claimed.

It is understood that, just as the two Contracting States and their political subdivisions are to be treated as residents of those States for purposes of Convention benefits, they also are entitled to benefits under Article 21.

Paragraph 2 permits the competent authority of the State in which income arises to grant Convention benefits in additional cases, even if the beneficial owner of the income does not meet the safe harbor standards of paragraph 1 (or the information is not available to make such a determination). This discretionary provision is included in recognition that, with the increasing scope and diversity of international economic relations, there may be cases where significant participation by third country residents in an enterprise of a Contracting State is warranted by sound business practice and does not indicate a motive of attempting to derive unintended Convention benefits.

Paragraph 3 defines the term "gross income" as used in paragraph 1(e)(ii).

Article 22. CAPITAL

This Article specifies the circumstances in which a Contracting State may impose tax on capital owned by a resident of the other Contracting State. At the time the treaty was signed, neither the United States nor Kazakhstan imposed a national-level tax on capital. There was some indication, however, that Kazakhstan might enact such a tax, and the purpose of this Article was to provide rules to deal with any such tax subsequently enacted by either State. The recently enacted tax code of Kazakhstan contains provisions for capital taxes on land, vehicles, and certain business assets. This Article specifically permits Kazakhstan to impose a capital tax on real property (as defined in Article 9 (Income from Real Property)) of a U.S. resident situated in Kazakhstan (paragraph 1) and on movable business assets forming part of the permanent establishment or fixed base of a U.S. resident in Kazakhstan (paragraph 2). Paragraphs 1 and 2 would also permit the United States to impose capital taxes on real property of a Kazakhstan resident located in the United States and on a Kazakhstan resident's business assets held in connection with a permanent establishment or fixed base in the United States. In the cases covered by paragraphs 1 and 2, the taxing right given to the State where the capital is

located is not an exclusive right; the State of residence may also tax.

Paragraph 3 provides that capital represented by ships, aircraft or containers owned by a resident of one Contracting State and operated in international traffic may be taxed only in the residence State. This is consistent with the rule of Article 8 (Shipping and Air Transport) that addresses the income from international transportation activities.

Paragraph 4 provides that all other items of capital not otherwise specified in the Article will be taxed exclusively by the residence State. For this purpose, a "resident" is defined under Article 4 (Residence). Thus, for example, a U.S. citizen may be a "resident" of Kazakhstan and would be subject to capital taxes in Kazakhstan under paragraph 4 but would also be subject to any capital tax in the United States under the saving clause of paragraph 3 of Article 1 (General Scope).

Article 23. RELIEF FROM DOUBLE TAXATION

In this Article, each Contracting State undertakes to relieve double taxation by granting a credit against its income tax for the income tax paid to the other country. It also provides a credit to a parent company (one owning at least 10 percent of the voting stock of a company that is a resident of the other State) for tax "indirectly" paid to that other State. Each Contracting State uses the foreign tax credit to avoid double taxation of income arising in the other State. The credit is subject to the limitations of domestic law, such as Code sections 59(a), 902, and 904.

Point 8 of the Protocol further elaborates on the provisions in this Article. Subparagraph (a) of point 8 provides that Kazakhstan will credit the U.S. tax imposed on U.S. citizens resident in Kazakhstan by reason of citizenship, subject only to the limitation to the amount of the Kazakh tax on non-Kazakhstan source income. This includes the portion of the U.S. tax imposed solely on the basis of citizenship in accordance with the saving clause of paragraph 3 of Article 1 (General Scope). Thus, the United States fully retains primary taxing jurisdiction with respect to U.S. source income and third-country source income of a U.S. citizen who is resident in Kazakhstan. Accordingly, it is not necessary to re-source any of the U.S. source income of such an individual to avoid double taxation. (Cf. Paragraph 3 of Article 23 (Relief from Double Taxation) of the U.S.-German income tax convention.)

Kazakhstan confirms in point 8 b) of the Protocol that, in computing the taxes on profits and income specified in Article 2 (Taxes Covered), it allows certain deductions to a Kazakh entity wholly owned by U.S. residents, to joint ventures involving U.S.

investors, and to permanent establishments of U.S. residents. The deductions specified in point 8 b) are the amount of wages actually paid and interest, whether or not paid to a bank and without regard to the term of the debt. The amount of interest allowed as a deduction, however, shall not exceed the limitation on interest deductions under Kazakhstan law, as long as the limitation permits deduction of at least an arm's length rate of interest, with a reasonable risk premium.² (Kazakhstan's new tax law, which was enacted by presidential decree on April 24, 1995, makes no distinction between foreign and domestic ownership for purposes of interest and wage deductions and generally permits full deduction of these expenses.)

Based upon the confirmation of deductions in point 8 b) of the Protocol, Article 23 provides that the Kazakhstan taxes referred to in Article 2 shall be treated as income taxes, and therefore are eligible for the foreign tax credit. Thus, when those Kazakhstan taxes are paid by ventures wholly or partly owned by U.S. investors, they will be eligible for foreign tax credits in the United States.

The deductions for wages and interest are critical to the agreement by the United States to provide a foreign tax credit for the Kazakh taxes covered under Article 2. The United States permits a credit only for foreign taxes imposed on net income, and the deduction of wages and interest is necessary to ensure that the base of the Kazakh tax is net income. Kazakhstan has an obligation under Article 2 (Taxes Covered) to notify the United States, through the competent authority mechanism, of significant changes in its law, including changes that deny or have the effect of denying, these significant deductions. The United States will not be obligated under the Convention to grant a foreign tax credit should Kazakhstan change its law in the future to deny these deductions. Moreover, the United States may, without regard to any treaty obligation, make an independent assessment of any other substantial change in Kazakh law to ensure that the Kazakh tax remains creditable under principles of U.S. domestic law.

Subparagraph c) of Point 8 of the Protocol provides that income tax paid by a Kazakh person that is treated as a partnership under U.S. principles will be treated by the United States as having been paid by the U.S. partners, pursuant to the

² Point 8 b) does not alter the general rule under Article 6 (Business Profits) that deductions will not be allowed for interest paid by a permanent establishment to the home office. Consequently, in accordance with Article 6 (Business Profits), a permanent establishment will be allowed to claim deductions for interest expenses only to the extent they are reasonably allowable to the permanent establishment.

rules of the Code. The Code rules regarding foreign taxes paid or accrued by a partnership are found in sections 702 and 901 and in Treas. Reg. § 1.901-1(a). Private letter rulings issued by the IRS confirm that the foreign taxes paid by a partnership, at least in the circumstances addressed by those rulings, "flow through" to its partners (P.L.R. 7934096 and P.L.R. 7211160390A).

Subparagraph d) of point 8 of the Protocol clarifies that the Convention does not provide for a "tax sparing" credit, that is, a credit for taxes waived under a tax holiday or other provision. It is firm U.S. treaty policy not to grant a treaty credit for taxes that are not in fact paid to the treaty partner; the foreign tax credit in the United States is available only for taxes actually paid or accrued to a foreign taxing authority. Subparagraph d) does, however, provide that, in the event the United States revises this policy or agrees in a treaty with another country to give a tax sparing credit, this Convention will be promptly amended to incorporate a tax sparing credit. If this Convention is so amended, approval by the United States Senate would be required before a tax sparing credit would be effective with respect to Kazakhstan.

24. NON-DISCRIMINATION

This Article ensures that citizens and residents of a Contracting State will not be subject to discriminatory taxation in the other Contracting State. This Article does not require identical treatment of taxpayers. Distinctions in tax treatment may be based upon differences in taxpayers' circumstances and in such cases are not discriminatory within the meaning of this Article. Certain examples of such treatment are discussed below.

Generally, non-discrimination under this Article means providing the better of national treatment or most-favored-nation treatment with respect to statutory rules and administrative practice; it does not require most-favored-nation treatment when citizens or residents of a third State are provided benefits under special agreements, such as bilateral income tax treaties with the third State. Thus, if Kazakh law imposes a more favorable tax regime on the income of joint ventures with a specified percentage of foreign capital vis-a-vis companies wholly owned by residents, the benefits of the favorable regime will also apply to joint ventures in which the foreign participation is by U.S. citizens or residents.

Paragraph 1 provides that a citizen of one Contracting State may not be subject to taxation or connected requirements in the other Contracting State which are different from or more burdensome than the taxes and connected requirements imposed upon a citizen of that other State or of a third State in the same circumstances. A citizen of a Contracting State is afforded protection under this paragraph even if the citizen is not a

resident of either Contracting State. Thus, a U.S. citizen who is resident in a third country is entitled, under this paragraph, to the same tax treatment in Kazakhstan as a citizen of any other country who is a resident of that third country and in the same circumstances.

It is understood, however, that for U.S. tax purposes, a U.S. citizen who is resident outside the United States, whether in Kazakhstan or a third country, is not in the same circumstances as a citizen of Kazakhstan who is a resident outside the United States, whether in Kazakhstan or a third country, because the U.S. citizen is subject to U.S. tax on his worldwide income and the Kazakhstan citizen is subject to U.S. tax only on his U.S. income. It is understood that neither Contracting State is required to grant to residents of the other Contracting State the same personal exemptions and deductions that it provides to its own residents to take account of marital status or family responsibilities.

Paragraph 2 of the Article provides that a permanent establishment in a Contracting State of a resident of the other Contracting State may not be less favorably taxed in the first-mentioned State than an enterprise of that first-mentioned State or of a third State that is carrying on the same activities. The latter, most-favored-nation, treatment does not extend to benefits granted to permanent establishments of residents of a third State in accordance with a special agreement with that third State, such as an income tax Convention.

Section 1446 of the Code imposes on any partnership, whether domestic or foreign, the obligation to withhold tax from a foreign partner's distributive share of income effectively connected with a U.S. trade or business. If tax has been over-withheld, the partner can, as in other cases of over-withholding, file for a refund. In the context of the Convention, this obligation applies with respect to a Kazakh resident partner's share of the partnership income attributable to a U.S. permanent establishment. There is no similar obligation with respect to the distributive shares of U.S. resident partners.

It is understood that this withholding provision is not a form of discrimination within the meaning of paragraph 2 of the Article, but merely a reasonable adaptation of the mode of taxation to the particular circumstances of nonresident partners. Like other withholding provisions applicable to nonresident aliens, this is 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. Cf. the "backup withholding" rules of section 3406 which apply only to U.S. citizens and residents and serve a similar purpose. (The

relationship between paragraph 2 and the imposition of the branch tax is dealt with below in the discussion of paragraph 5.)

Paragraph 3 prohibits discrimination in the allowance of deductions. When a resident of a Contracting State pays interest or royalties or makes other disbursements to a resident of the other Contracting State, the first-mentioned Contracting State must allow a deduction for those payments in computing the taxable profits of the enterprise under the same conditions as if the payment had been made to a resident of the first-mentioned State. An exception to this rule is provided for cases where the provisions of paragraph 1 of Article 7 (Associated Enterprises), paragraph 6 of Article 11 (Interest) or paragraph 6 of Article 12 (Royalties) apply, because all of these provisions permit the denial of deductions in certain circumstances in respect to excess (not at arm's length) payments involving related persons. Paragraph 3 is not intended to limit in any way the application of domestic thin capitalization rules, such as section 163(j), which may deny or defer deductions for interest, as long as such rules continue to be consistent with the arm's length standard. The term "other disbursements" is understood to include a reasonable allocation of executive and general administrative expenses, research and development expenses and other expenses incurred for the benefit of a group of related persons which includes the person incurring the expense.

Paragraph 3 also provides that any debts of a resident of a Contracting State to a resident of the other Contracting State are deductible in the first-mentioned Contracting State in computing taxable capital under the same conditions as if the debt had been contracted to a resident of the first-mentioned State. This Article also applies to taxes imposed by local authorities in either Kazakhstan or the United States. (See discussion of paragraph 6.) Thus, for example, if a tax is imposed on the value of real property net of debt, the same deduction must be allowed with respect to debt of creditors who are residents of either Contracting State.

Paragraph 4 requires that a Contracting State not impose other or more burdensome taxation or connected requirements on a company which is a resident of that State that is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, than the taxation or connected requirements it imposes on similar resident companies owned by residents of the first-mentioned State or of a third State. It is understood that the U.S. rules which impose tax on a liquidating distribution of a U.S. subsidiary of a Kazakh company and the rule restricting the use of small business corporations to U.S. citizens and resident alien shareholders do not violate the provisions of this Article.

Paragraph 5 of the Article specifies that no provision of the Article will prevent either Contracting State from imposing the branch profits tax described in paragraph 5 of Article 10 (Dividends) or the branch level interest tax described in paragraph 7 of Article 11 (Interest).

Paragraph 6 provides that, notwithstanding the specification of taxes covered by the Convention in Article 2 (Taxes Covered), the non-discrimination protection in this Article applies to taxes of every kind and description. Although not explicitly so stated, this rule is intended to extend to taxes at all levels of government. The reference to taxes of political subdivisions was omitted largely for drafting reasons with respect to the Russian language text. Customs duties are not considered to be taxes for this purpose.

The saving clause of paragraph 3 of Article 1 (General Scope) does not apply to this Article, by virtue of the exceptions in paragraph 4(a) of Article 1. Thus, for example, a U.S. citizen who is resident in Kazakhstan may claim benefits in the United States under this Article.

Article 25. MUTUAL AGREEMENT PROCEDURE

This Article provides for cooperation between the competent authorities of the Contracting States to resolve disputes that may arise under the Convention and to resolve cases of double taxation not provided for in the Convention.

Paragraph 1 provides that where a person considers that the actions of one or both Contracting States will result for him in taxation that is not in accordance with the Convention he may present his case to the competent authority of his State of residence or citizenship. It is not necessary for a person first to have exhausted the remedies provided under the national laws of the Contracting States before presenting a case to the competent authorities. Also, the Convention does not limit the time during which a case may be brought.

Paragraph 2 provides that, if the competent authority of the Contracting State to which the case is presented considers the case to have merit, and if it cannot reach a unilateral solution, it will seek agreement with the competent authority of the other Contracting State to avoid taxation not in accordance with the Convention. If agreement is reached under this provision, it is to be implemented even if implementation would be otherwise barred by the statute of limitations or by some other procedural limitation, such as a closing agreement. Because, as specified in paragraph 2 of Article 1 (General Scope), the Convention cannot operate to increase a taxpayer's liability, the Convention overrides time or other procedural limitations of domestic law

only for the purpose of making refunds (not for the purpose of imposing additional tax).

Paragraph 3 authorizes the competent authorities to seek to resolve difficulties or doubts that may arise as to the application or interpretation of the Convention. The paragraph includes a non-exhaustive list of examples of the kinds of matters about which the competent authorities may reach agreement. They may agree to the same attribution of income, deductions, credits or allowances between a resident of one Contracting State and its permanent establishment in the other, and to the allocation of income, deductions, credits or allowances between persons. These allocations are to be made in accordance with the arm's length principles of Article 6 (Business Profits) and Article 7 (Associated Enterprises). The competent authorities may also agree to settle a variety of conflicting applications of the Convention, including those regarding the characterization of items of income, the application of source rules to particular items of income, differences in meanings of a term, and differences in applying penalties, fines and interest. Agreements reached by the competent authorities under this paragraph need not conform to the internal law provisions of either Contracting State. The competent authorities also may address cases of double taxation not foreseen by the Convention and attempt to reach an agreement that would prevent that result.

Paragraph 4 authorizes the competent authorities to communicate with each other directly for these purposes. It is not necessary to communicate through diplomatic channels.

Paragraph 5 provides for an arbitration procedure, to be implemented subsequently by an exchange of diplomatic notes. The competent authorities will consult after the Convention has been in force for three years to decide whether it is appropriate to exchange the notes. One of the key factors for the U.S. competent authority in making that decision will be the U.S. experience under the arbitration provisions of the U.S.-Germany treaty, which entered into force in 1991 and which contains the first arbitration provision of any U.S. income tax treaty. If the competent authorities decide to exchange the diplomatic notes to implement an arbitration procedure in this Convention, they will also agree to procedures to be followed in arbitration. It is expected that such procedures will ensure that arbitration will not generally be available where matters of either State's tax policy or domestic law are involved, that the arbitrators will be bound by the Convention's confidentiality and disclosure provisions, and that the decision in arbitration will be premised upon the Convention, the provisions of each State's domestic law, and the principles of international law. The procedures to be established by the exchange of notes also will address the costs of arbitration and the composition of the arbitration board.

Point 9 of the Protocol also provides for the competent authorities to consult whenever either believes that the law of the other Contracting State is or may be applied in a manner that significantly limits or eliminates a benefit provided by the Convention. In that event, the competent authorities shall consult with a view to restoring the balance of benefits. The State of which the request to consult is made shall accede to the request by beginning consultations within three months of the request. If the States are unable to agree on how to modify the Convention to restore the balance of benefits, the affected State may terminate the Convention in accordance with Article 29 (Termination) even if the Convention has been in force fewer than five years. Alternatively, the affected State may resort to other procedures permitted under the general principles of international law.

This Article 25 represents another exception to the saving clause of paragraph 3 of Article 1 (General Scope); the benefits of this Article are thus available to residents of either Contracting State and to U.S. citizens. (See paragraph 4(a) of Article 1.)

Article 26. EXCHANGE OF INFORMATION

This Article provides for the exchange of information between the competent authorities of the Contracting States. The information to be exchanged is that necessary for carrying out the provisions of the Convention or the domestic laws of the United States or Kazakhstan concerning the taxes covered by the Convention. For the purposes of this Article, the taxes covered by the Convention include all taxes imposed at the national level (see paragraph 4). Exchange of information with respect to domestic law is authorized insofar as the taxation under those domestic laws is not contrary to the Convention. Thus, for example, information may be exchanged with respect to any national level tax for purposes of implementing the taxes covered by Article 2, even if the transaction to which the information relates is a purely domestic transaction in the requesting State.

Paragraph 1 states that information exchange is not restricted by Article 1 (General Scope). This means that information may be requested and provided under this Article with respect to persons who are not residents of either Contracting State. For example, if a third-country resident has a permanent establishment in Kazakhstan that engages in transactions with a U.S. resident, the United States could request information with respect to that permanent establishment, even though it is not a resident of either Contracting State. Such information would not be routinely exchanged, but may be requested in specific cases.

Paragraph 1 also provides assurances that any information received in accordance with this Article will be treated as

secret, subject to the same restrictions on disclosure that apply to information obtained under the laws of the requesting State. Information received may be disclosed only to persons, including courts and administrative bodies, concerned with the assessment, collection, enforcement or prosecution in respect of the taxes to which the information relates, or to persons concerned with the administration of these taxes. The information must be used by such persons in connection with these designated functions. Persons concerned with the administration of taxes in the United States include the tax-writing committees of Congress and the General Accounting Office. Information received by these bodies is for use in the performance of their role in overseeing the administration of U.S. tax laws. Information received under this Article may be disclosed in public court proceedings or in judicial decisions.

Paragraph 2 explains that the obligations undertaken in paragraph 1 to exchange information do not require a Contracting State to carry out administrative measures that are at variance with the laws or administrative practice of either State. Nor is either State obligated to supply information not obtainable under the laws or administrative practice of either State. Thus, there is no obligation to furnish information to the other Contracting State if either the requested State or the requesting State could not obtain such information for itself in a domestic case. There is also no obligation to disclose trade secrets or other information, the disclosure of which would be contrary to public policy. Either Contracting State may, however, at its discretion, subject to the limitations of the paragraph and its internal law, provide information which it is not obligated to provide under the provisions of this paragraph.

The Memorandum of Understanding between the two States clarifies that, notwithstanding any provision of either State's law, information contained in banking documents, including banking documents pertaining to third persons involved in transactions with residents of either State, will be made available under this Article, in civil or criminal tax investigations. Thus, domestic laws regarding bank secrecy may not be invoked to prevent the exchange of banking information or documents under this Article.

Paragraph 3 provides that, when information is requested by a Contracting State in accordance with this Article, the other Contracting State is obligated to obtain the requested information as if the tax in question were the tax of the requested State, even if that State has no direct tax interest in the case to which the request relates. The paragraph further provides that the requesting State may specify the form in which information is to be provided (e.g. depositions of witnesses and authenticated copies of original documents), so that the information can be used in the judicial proceedings of the

requesting State. The requested State should provide the information in the form requested to the same extent that it can obtain information in that form under its own laws and administrative practices with respect to its own taxes.

Article 27. DIPLOMATIC AGENTS AND CONSULAR OFFICERS

This Article confirms that any fiscal privileges to which members of diplomatic or consular missions are entitled under the general provisions of international law or under special agreements will apply, notwithstanding any provisions of this Convention. Thus Article protects any fiscal privileges of technical staff and other employees of such missions as well as those with diplomatic status.

Article 28. ENTRY INTO FORCE

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

Paragraph 2 provides that the Convention will enter into force on the date on which instruments of ratification are exchanged. The Convention will have effect with respect to taxes withheld at source on dividends, interest and royalties for amounts paid or credited on or after the first day of the second month following the month in which the Convention enters into force. For example, if the Convention were to enter into force on July 1, 1995, the withholding rates on dividends, interest and royalties would be reduced (or eliminated) for amounts paid on or after September 1, 1995. For all other income taxes, the Convention will have effect for taxable periods beginning on or after January 1 of the year in which the Convention enters into force.

The 1973 Convention will cease to have effect when the provisions of this Convention take effect. Point 10 of the Protocol provides that a person entitled to the benefits of the Convention may elect to continue to apply any legal rules under the 1973 Convention for the first taxable year in which this Convention would otherwise have effect. This is a taxpayer-by-taxpayer election. This provision can be relevant, for example, to a teacher or journalist who may be entitled under the 1973 Convention, but not under this Convention, to a special exemption from tax in the host country with respect to the individual's remuneration for those services. In such a case, the individual could elect to apply all of the legal rules applicable under the 1973 Convention for the first taxable year, but he could not choose, for example, to apply the 1973 Convention rules with respect to personal service income and the rules of this

Convention with respect to dividend income. A U.S. company that has already begun to perform a construction contract or to explore for oil in Kazakhstan might also elect to apply the rules of the 1973 Convention because that Convention contains a more generous permanent establishment threshold (36 months) than does the proposed Convention (12 months). (However, the maximum benefit that such a company could obtain from the 1973 Convention is 12 additional months.)

Article 29. TERMINATION

The Convention is to remain in effect indefinitely, unless terminated by one of the Contracting States in accordance with the provisions of this Article. A Contracting State may terminate the Convention at any time after 5 years from the date of its entry into force by giving written notice through diplomatic channels to the other Contracting State at least six months in advance. If such notice is given, the Convention will cease to apply in respect of taxes withheld on dividends, interest and royalties paid or credited on or after the first of January following the six month period and with respect to other taxes for taxable periods beginning on or after the first of January following the six month period. Thus, for example, if notice of termination is given in July or later of a calendar year, the termination will not be effective as of the following January 1 but as of the second January 1, because the notice period must continue for at least six months.

Article 29 relates to unilateral termination of the Convention by a Contracting State. The Article does not prevent the Contracting States from entering into a new bilateral agreement that supersedes, amends or terminates provisions of the Convention either prior to the expiration of the five year period or without the six month notification period.

Point 9 of the Protocol relates to unilateral termination of the Convention by a Contracting State before the expiration of the five year minimum period provided for in paragraph 1 of Article 29. This provision, discussed in more detail in the explanation of Article 25 (Mutual Agreement Procedure), above, was included at the request of Kazakhstan to address the possibility of future U.S. legislative provisions overriding one or more treaty provisions.

PROTOCOL

The provisions of the Protocol are an integral part of the Convention. Each has been described in the discussion of the article to which it refers.

MEMORANDUM OF UNDERSTANDING

The Memorandum of Understanding reflects the Contracting States' mutual interpretation of certain Convention provisions and is equally binding on both States. Its provisions have been described in the discussion of the articles to which they refer.